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Economic Opening up of Russia: Establishment of New EU-RF Trade Relations in View of EU Eastern Enlargement

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Abstract The EU's economic co-operation and political dialogue with Russia take place in many spheres touching the Kaliningrad issue, WTO membership, a war against terrorism, energy dialogue, and the consequences of the EU Eastern Enlargement that took place in May 2004. Undoubtedly, the European Union and the Russian Federation have also an important trade relationship. The interest of both parties in maintaining and strengthening this co-operation is even more important because of the EU Enlargement as they are now direct neighbours. The aim of the research was to look into the question how the EU Enlargement would influence Russia's opening up as well as its trade relations with the EU-25 with special focus on EU new members from Central and Eastern Europe. The paper has complex contents and present the subject in broad perspective. First chapter gives the theoretical base (theory of trade creation and diversion) on which analysis on current developments were made. The second describes the economic situation in Russia and its opening-up for trade. The third chapter gives detailed background of EU-Russian bilateral economic relations supported by statistical data. Furthermore, the existing trade regime and current changes in EU- Russia trade regime were described and analyzed. The fourth chapter describes thoroughly the process of the European integration generally, what it means for the new members and non-members in order to show the complexity of the EU Eastern Enlargement. The possible consequences of the EU Enlargement on EU-Russia and CEE countries – Russia trade relations are presented further. Then, in the end of the paper hypothesis is discussed that the establishing a Common European Economic Space (CEES) between the EU and Russia is a condition for overcoming any negative effects of Enlargement for both sides.By studying this subject it was hoped to shed some new light on the EU-Russia relations, presented fresh approaches and contribute some new results which in turn will call for some reassessment of what has already been done in the EU-Russia relations. Research was based on government and diplomatic documents, papers statistical data, solid expertise and broad cross-section of economists' opinion and other specialized publications or field interviews found on English, Polish and Russian web sites, in books and newspapers.

Zusammenfassung: Die wirtschaftliche Zusammenarbeit und der politische Dialog zwischen der EU und Russland findet auf vielen Felder statt, u.a. im Zusammenhang mit dem Status des Kaliningrader Gebietes, der WTO-Mitgliedschaft, Terrorismusbekämpfung, Energieversorgung und den Konsequenzen des EU-Beitritts der am 1. Mai 2004 vollzogen wurde. Zweifelsohne pflegen die Europäische Union und Russland wichtige Handelsbeziehungen. Das Interesse beider Parteien am Erhalt und der Intensivierung der Kooperation ist auch deswegen von wachsender Bedeutung, weil die beiden nach der Erweiterung nun direkte Nachbarn sind.Das Ziel dieses Diskussionbeitrages ist es, ein Blick darauf zu werfen, wie die EU-Erweiterung Russlands Öffnung beeinflussen und seine Handelbeziehungen zu den Ländern der EU-25 verändern wird besondern im Hinblick auf die neuen EU-Mitgliedsstaaten in Mittel- und Osteuropa.Im ersten Kapitel wird eine theoretische Basis für die Analyse der gegenwärtigen Entwicklungen gegeben (Theorie der Handelsschaffung und der Handelsumlenkung). Das zweite beschreibt die wirtschaftliche Situation Russlands und seine Öffnung in Bezug auf den Handel. Das dritte Kapitel liefert einen detaillierten Hintergrund der bilateralen wirtschaftlichen Beziehungen auf Basis von statistischen Daten. Das vietre Kapitel beschreibt den Prozess der europäischen Integration im Allgemeinen und nimmt Bezug auf seine Bedeutung für die neuen Mitglieder und Nicht-Mitglieder. Zum Ende wird diskutiert, ob die Schaffung eines Gemeinsamen Europäischen Wirtschaftsraumes (GEWR) zwischen der EU und Russland eine Voraussetzung für die Überwindung der negativen Effekte der Erweiterung für beide Seiten ist.

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1. Introduction

Enlarging European Union Eastwards

On **May 1st 2004**, ten countries became members of the European Union: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia. Objective is to welcome Bulgaria and Romania as the EU members in 2007 (EUROPEAN COMISSION 2004).

The Eastern Enlargement, which is **fifth enlargement** of the European Union, is one of the most important opportunities for the EU and for Central and East European (CEE) countries at the beginning of the 21st century. It is a unique, historic task to further the integration of the continent by peaceful means, extending a zone of stability and prosperity to new members. According to the European Comission's (EC) estimates, **the benefits of enlarging the Union** to include these countries are political, economic, and cultural:

- The addition of more than 100 million people, in rapidly growing economies, to the EU's market of 370 million will boost economic growth and create jobs in both old and new member states.
- There will be a better quality of life for citizens throughout Europe as the new members adopt the EU policies for protection of the environment and the fight against crime, drugs and illegal immigration.
- The arrival of new members will enrich the EU through increased cultural diversity, interchange of ideas, and better understanding of other peoples.
- The Enlargement will strengthen the Union's role in world affairs – in foreign and security policy, trade policy, and the other fields of global governance.

The economic analyses of the Commission maintained that benefits were visible in candidate countries even before the Enlargement (EUROPEAN COMISSION 2003):

- In Central and Eastern Europe, **stable democracies** had emerged, with democratic institutions and increased respect for minorities.
- The **economic reforms** in these countries had led to high rates of economic growth (higher than the EU) and better employment prospects.
- This process had been helped and encouraged by the prospect of the EU membership, and by the **EU's financial assistance**.
- As a result the Union enjoyed **growing trade** with these countries (€ 17 billion trade surplus in 2000), and this generated employment and growth in the member states.

Numerous economic analyses have concluded that the benefits of the Enlargement will outweigh the costs. Although the benefits are relatively larger for the new member-countries, because they start from a lower economic base (their economies represent only about 6% of the GDP of EU-15), there are gains for both sides. Moreover, the new members, already exposed to the challenge of globalisation, will help the Union to surmount it.

From economical point of view the process of the Enlargement generally means an expansion of European Union's market and the opening of previously closed CEE countries markets by removing existing trade barriers. It should be recognized, furthermore, that the creation of a single European Union's market is automatically linked with closure toward those companies and economic actors operating from non-member countries who cannot directly refer to the laws and liberties granted within the single market. Therefore, before reviewing these consequences, it will be instructive first to base them on the theoretical benefits and costs of economics integration, to which I will refer many times in my paper.

Theory of Economic Integration

There are following stages of international economic integration:

- A **free trade area** is established when a group of countries abolishes restrictions on mutual trade but each member country retains its own tariff and quota system on trade with third countries. An **industrial free trade** covers only trade in industrial products while a full free trade area includes all products.
- A **custom union** is created when a group of countries removes all restrictions on mutual trade and also sets up a common system of tariffs and quotas with respect to third countries. A custom union becomes a **common market** with the removal of all restrictions on the movement of productive factors-labour, capital, and enterprise.
- The completion of the final stage of **economic union** involves a full integration of the member economies with authorities responsible for economic policymaking. In particular, an economic union requires a single monetary system and central bank, a unified fiscal system, and a common foreign economic policy.

Because the international economic integration involves both free trade among its member countries (**liberalization**) and, at the same time, restrictions on imports from non-member or third countries (**protection**), it has both positive and negative effects. A positive effect occurs when the elimination of internal tariffs and other barriers stimulates new trade among the member countries that does not displace third-country imports. That is to say, the customs union induces a shift from a high-cost producer inside the union to a lower cost producer also inside the union. This positive effect is called **trade creation**. On the other hand, a negative trade effects occurs when member countries now buy from each other what they formerly bought from third countries. Known as **trade diversion** this negative effect results from a shift from a lower producer outside the union to a higher cost producer inside the union (see: statistic analyses in **Appendix 1**).

On one side, third countries may significantly benefit from an enlarged Union. A single set of trade rules, a single tariff, and a single set of administrative procedures were applied not only just across the existing Member States but across the Single Market of the enlarged Union. This may simplify dealings for third-country operators within Europe and improve conditions for investment and trade. On the other side, economic integration may declines trade between the members and the outsider and worsens its terms of trade. However, it is difficult and also to early to estimate and predict now what real economic consequences it has on the third countries. Therefore, it is obvious that the impact of this Enlargement as economic integration of CEE countries with the EU on Russia, which will stay outside the EU, its economy and EU-Russia trade relations is nowadays a controversial question and rise many doubts. They are strengthened by the fact that since Lithuania and Poland are members of the EU, the Russian enclave – Kaliningrad - became an island surrounded on all land borders by a totally different, political, economic and military entity.

The EU and Russia should, therefore, develop closer cooperation and new trade relations in order to compensate any negative effect connected with the Eastern Enlargement and to prevent any crowding-out of Russia.

In the framework of my paper, I would like to look into the question how the process of the EU Enlargement may influence Russia's future trade and its economic opening up and what measurement should be undertaken to offset any negative impact on country's economic growth and productivity and help to strengthen EU-Russia trade relations. The paper then will discuss the option of establishing Common European Economic Space (CEES) as an adequate solution and the main condition for succeeding in this issues.

2. Making Russia's Economy More Open

Developing and CIS countries with Russia are becoming closely linked to the global economy. This process affects development of market integration, interdependence among countries, provides opportunities to exploit country' comparative advantages. Nevertheless the main **aims of transition**: trade liberalization, effective privatisation and macro stabilisation have not been fully achieved in Russia. **M. Porter** considers that most developing countries are at the first stage of development and building comparative advantages in labour-intensive and natural resource-intensive goods. Further progress in providing reforms can be ensured via restructuring, and privatising of key enterprises in reorganising banking sector, investing in capital-intensive branches. The openness of the country is closely connected with the development of well-functioning market-based institutions, an efficient state management of public business and the guarantee of property rights and adherence of the rule of law.

2.1 Economic Development

2.1.1 GDP and Industrial Production

Russia has made considerable progress in achieving macroeconomic stabilisation. In period between the fall of the Soviet Union and the severe 1998 financial crisis, GDP and standards of living declined dramatically, social security worsened, while poverty levels rose markedly. After the financial crisis the devaluation of the rouble, which boosted demand for local production, successful macroeconomic stabilisation polices and unexpectedly high world energy process, brought about a recovery. GDP rebounded in 1999, increasing by 5.4% and accelerated to a 9% annual rate in 2000, as the economy benefited from a further sharp increase in oil prices.

Nevertheless, according to Federal State Statistics Service (Rosstat) estimates GDP decelerated to around 5% in 2001 and to 4.7 % in 2002 also mainly in a context of lower oil prices and worsening world economy, what may give the assumption that the Russian economy is operating below its potential and the current growth mechanism is not sustainable in the long term.

However, after this slowdown in growth, the economy in 2003 grew at impressive rated estimated at 7.3%, which brings GDP at current prices to 13.3 trillion rubles. This tendency was followed also in the first half of 2004 when GDP increased by estimated 7.4%, with the slowdown observed in the third quarter of 2004. Nevertheless, growth of more than 7% in

2003 and in first half of 2004 brought the cumulative expansion since the depth of the 1998 crisis to about 39.4% (WORLD BANK 2004).

For the first time in a long time, in 2003 growth was driven by investment. Industrial production grew at 7% (compared to 3.7% in 2002) and services growing at 7.4 % (5.5%). The increase was observed in natural recourses sector as well as in domestic manufacturing. Although growth of the natural resource sectors exceeds growth of domestic manufacturing, there has been reported increase in activities outside the natural resource sectors and it appears as if manufacturing 'caught up' a little in 2003. Overall jump in the growth rates of domestic manufacturing was driven by its sub-sector, namely machine building.

These positive trends that appeared in 2003 have also carried in 2004 (**Table 1**). However, while in 2003 the manufacturing sector outpaced significantly resource-based industries, in 2004 was reported slowdown in non-resources branches of industry (WORLD BANK 2004).

Table 1 :Growth in Resource and Manufacturing Industries (%)

	1999	2000	2001	2002	2003	2004 – 9M
Non-ferrous metals	10.0	15.0	4.9	6.0	6.2	3.6
Ferrous metals	17.0	16. 0	-0.2	3.0	8.9	5.2
Fuel and energy	2.4	5.0	6.1	7.0	9.3	7.7
Wood and processing	18.0	13.0	2.6	2.4	1.5	3.6
weighted average	**9.3**	**10.4**	**4.2**	**5.5**	**7.8**	**6.0**
Electricity	-1.0	1.8	1.6	-0.7	1.0	0.2
Chemical	24.0	15.0	5.0	1.6	4.4	7.9
Machine building	17.0	20.0	7.2	2.0	9.4	12.7
Construction materials	10.0	13.0	5.5	3.0	6.4	5.9
Light industry	12.1	21.0	5.8	-3.4	-2.3	-5.9
Food	4.0	14.0	8.4	6.5	5.1	4.4
Weighted average	**10.6**	**14.3**	**6.3**	**2.5**	**5.6**	**6.7**

Source: Rosstat (2004), Russian Economic Report no 9, www.worldbank.org.ru

Russia's dependence on the oil price was slightly slipping since the end of 2002, but still strong (GAVRILENKOV 2004) and cannot be ignored. Russia's high growth continues to be dependent on high prices of oil. The price for Russian oil increased from an average of 21 to 24 USD per barrel or by 15 % over the course of 2003, with a peak in the run up to the Iraq war. It is historically proved, that Russia has never grown faster than 5.5% without an increase in the price of oil. Therefore, Russia's growth depends of this factor (WORLD BANK 2004). The direct independence between oil price and export value in years 2000-2003 shows further Table 3.

The oil bonus also continued to increase the consumption of non- tradables and so helped to modify the structure of GDP further from manufacture of goods to the production of services in 2003 (WORLD BANK 2004).

Table 2 :Changes in GDP Structure (%)

	1999	2000	2001	2002	2003	Growth in 1999-2003
GDP	100	100	100	100	100	38.2
Production of goods	45.2	45.0	42.9	40.3	40.2	46.5
Production of services	54.8	55.0	57.1	59.7	59.8	28.3
market services	46.0	46.6	48.0	50.0	49.0	32.8
non-market services	8.9	8.4	9.1	9.7	10.8	7.4

Source: Rosstat (2004), Russian Economic Report no 7, www.worldbank.org.ru

High growth in 2003 and in the first half of 2004 and some structural changes that became recently visible can be explained not only by oil high prices but also by the fact that there are more and more enterprise founded after the start of systemic reform and growing up under competitive conditions. The macroeconomic performance already in 2002 clearly indicated that the country can no longer rely on the advantages of 'easy' growth and repeat the same growth pattern which emerged after the 1998 crisis. A rapid rise in incomes in recent years has shifted consumer demand toward higher-quality goods that could not yet be produced in Russia. Domestic manufacturers throughout the market, therefore, realized that to compete with imports, they need to offer better products, which means they need to invest in new productive capacities. (GAVRILENKOV 2004). Nevertheless, the decline in manufacturing industries and the overall slow in growth the third quarter of 2004 only confirmed that there are some obstacles that unable manufacturers to develop their businesses. Among such barriers are mentioned very often: increasing competitive pressure in manufacturing from imports and rising domestic costs as well regulatory uncertainty.

2.1.2 Capital Investment

The relatively low oil price in 2002 has affected capital investment in the fuel and energy sector directly. Since investment in this sector accounts for approximately 50 % of all investment this, by itself, may have impaired the rest of the economy. Moreover, the real appreciation of the ruble between 1995 and 1998 seriously undermined the competitiveness of industries other than energy and non-natural resources, discouraging investment in such industries. Although the rouble's devaluation in 1998 has improved the competitiveness of sectors other than energy and natural resources, it has sill not entailed any significant investment flows to these sectors. The obvious reason for this that investment in such sectors depends on longer-term expectations concerning the development of the real exchange rate of the rouble.

However, in 2003 there was a significant rise in the investment activity of enterprises and organisations. According to Rosstat, fixed investment increased by 12.5%, compared with 2.6% in 2002. The most considerable economic development in 2003 is that the economy finally experienced a significant increase in investment demand. (WORLD BANK 2004). The major factor of growth in fixed capital investment in 2003 was also due to the improved financial standing of enterprises in many sectors, including the export-oriented industries, which accounted for a large portion of total investment. In the first quarter of 2004 the investment grew even at faster rates comparing with the same period of 2003.

Nevertheless, it is with respect to investment data that disagreements between optimists and pessimists are most pronounced. The assessment depends on which enterprise segment one looks at. Disaggregating the statistical evidence suggests (i) accelerating investment growth in services and several “new” sectors; (ii) decelerating investment growth in domestic “old’ industries; and (iii) less linkage between investment in the oil and gas sector and price increases than previously (because current high energy prices are not expected to last).

2.1.3 Inflation

Russia has made considerable attempt in reducing inflation in the past several years, largely through the adoption of sensible fiscal and monetary policies. (GLOBAL INSIGHT 2004).

According to Rosstat estimates, consumer price inflation registered at 9.3% for the first ten months of 2004 and is likely to exceed the annual target of 10%. The pace, however, has been slower in 2004 than in 2003 despite much higher current account inflows from high oil prices and a less restrictive monetary policy.

2.1.4 Exchange Rate and Foreign Trade

The sharp appreciation of the Euro against the US dollar in the second half of 2002 caused Russia’s effective real exchange rate (REER) to depreciate by 0.7%, the first real depreciation since 1998. In 2003 the ruble’s real value against the USD increased by 19% (WORLD BANK 2004). With the lion’s share of exports (such as oil) denominated in USD and a significant share of imports coming from the Euro-zone, an appreciation in the exchange rate of the Euro versus the USD depreciates the ruble’s real exchange rate: it makes imports more expensive and lowers the value of exports.

Fortunately, for Russia manufactures, much of the competition in domestic markets is from goods denominated in euro, and they are benefiting from the euro’s constant strengthening and this trend seems to continue (GLOBAL INSIGHT 2004)

International trade in 2003 was characterized by substantially increased export and import values. While export growth was driven by very high prices for Russia’s main export goods (increase in the price of oil), import growth resulted from the continuing real appreciation of the ruble combined with rapid increase in real income and purchasing power (WORLD BANK 2004).

Table 3 :Russia’s Trade (USD billion) and Crude Oil Price (USD/barell)

	2000	2001	2002	2003
Export	105.6	101.9	107.6	134.4
Import	44.9	53.8	61.0	74.8
Trade Balance	60.7	48.1	46.6	59.6
Crude oil price	24.0	20.9	21.0	24.0

Source: Central Bank of Russia (2004), www.cbr.ru

In January – August in 2004 the term of trade with foreign countries were even better than in the same period last year owing to a more rapid growth in export prices. Exports expanded 27.3% in January-August 2004 compared to the same period last year, to 109.7 USD billion against 86.2 USD billion in January-August 2003. Export growth was mainly due to a rise in the contract prices of major export commodities – oil and gas, the price for which exceeded 35 USD/barrel in 2004, as well as due to the overall growth in export volumes. Imports, however increased 24.8% in that period year on year to stand at 58.5 USD billion against 46.9 USD billion in January-August 2003. Growth in imports was largely due to the increase in the value of investment goods such as machinery, equipment and transport vehicles. (CENTRAL BANK OF RUSSIA 2004).

2.1.5 Growth Prospects

Despite observed overall positive facts, there are facts that are not optimistic for Russia's growth, the reason for that is that increases in export values are almost completely based on international price increases for such goods, what means that the growth of the Russian economy relies mainly on evolution of world market prices, which entails significant exposure to potential fluctuations and crises in those segments (BANK OF FINLAND 2002). Consequently, the falling prices of fuels and raw materials or discrepancy of overestimated exchange rate ruble to US dollar may undermine Russia's economic growth -which is a key question for all transition countries, especially for those which have a major budget deficit and foreign debt problem. The point can be confirmed, for example, by the fact that the rise in oil price over 1999-2000 contributed to higher profits for oil companies, which in turn meant growing investment. Similarly, a fall in the oil price in 2002 resulted in a drop in investment and hence industrial output what was described earlier.

This fact can be explained by the **theory of trade policy.** According to this theory, **terms of trade** – a measure of the trading success of a country by comparing the prices of its imports with the prices of its exports- is better for developed than for developing countries. The reason for that is that developed countries export mainly manufacturing products whereas developing countries raw materials.

Generally, as table at the next page indicates, if export prices rise faster than import prices, terms of trade are said to improve. A fall in the exchange rate will have an unfavourable effect on the terms of trade. Therefore, countries like Russia whose growth is mainly powered by the export, which is resource oriented and includes oil, natural gas and other raw materials (chemical commodities, timber, fish products, non-ferrous metal, and wasted materials) will never have higher and, what is more important, sustainable capital inflows in long term.

Terms of trade of countries who export raw materials	**Terms of trade of countries who export manufacturing products**
a) if demand on the world market rises, this measure will fall, because: - prices of exported goods (raw materials etc) rise slowly - prices of imported goods rise fast	a) demand on the world market rises, this measure will rise, because: - prices of exported goods rise fast - prices of imported goods rise slowly
b) if demand on the world falls this terms of trade will also fall, because: - prices of exported goods fall fast. - prices of imported goods fall slowly	b) if demand on the world falls this factor also will rise, because: - prices of exported goods fall slowly - prices of imported goods fall fast

Source: Author

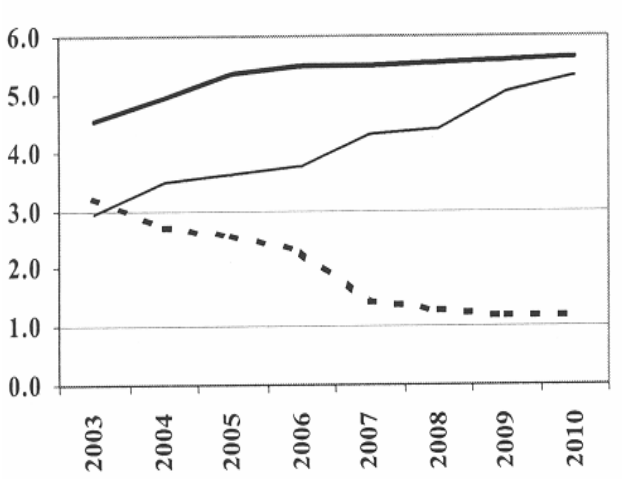
The fact is, what already mentioned, that Russian economy remains extraordinary dependent on the energy sector and other production of raw and semi-processed commodity exports as a source of growth. (GLOBAL INSIGHT 2004). The boost in oil prices that accompanied the run-up to the U.S-led military operations in Iraq sharply re-accelerated Russian economic growth in the first half of 2003 and launched an investment boom as the financial situation of Russian enterprises improved dramatically compared with a year earlier (GLOBAL INSIGHT 2004). However, the manufacturing sector largely suffers from the lack of investment which leave it internationally uncompetitive. Russian manufacturers have particularly suffered from competition of exports in the home market. Therefore, the priority of Russian trade policy should be to promote the development of those sectors that have the potential to growth and which are not vulnerable to terms-of-trade shocks e.g. science-intensive sub-sectors (pharmaceuticals, computers, aerospace, etc.) and specialised supplier sub-sectors (compressors, furnaces, agricultural tractors, machine-tools, weapon and ammunition, television and radio transmitters and receivers etc.). Among the market-economy countries Russia has the lowest share of textile, leather and clothing products in export. RECEP Comparative analysis of the development of **manufacturing exports** to the European Union from 1993 to 2002 shows a generally poor performance by Russia. Such fact may underline the importance of maintaining solid macroeconomic policies and continuing the implementation of radical economic reforms-which despite natural resource prices are nowadays the most important factors that determine Russia's growth over the medium term (RECEP 2002).

Taking account of the fact that growth in Russia is still dependent on commodity prices and continued reform implementation, World Bank Russia Office depicted **four possible scenarios of Russia' growth in 2003-2010**:

- Scenario 1 – high natural resource prices, continued reform implementation
- Scenario 2 - high natural resource prices, lack of reform implementation
- Scenario 3 – low natural resource prices, continued reform implementation
- Scenario 4 – low natural resource prices, lack of reform implementation

The resulting scenarios are suggestive in that they show four distinct patterns, and they show how reform implementation becomes the critical factor in attaining high growth rates. As figure 7 indicates, both scenario 1 and 3 have accelerating growth rates that will merge toward 2010, despite a considerable difference in the underlying oil price. On the other extreme, even with high oil prices throughout the period but without the benefit of continued reform implementation, growth rates in scenario 2 declines from 3.2% in 2003 to slightly more than 1% in 2010. Scenario 4, with low oil prices and no reform implementation is not depicted in figure 3, but would simply be below all others.

Fig.1 Growth Rate Dynamics, % (simulation results)



Source: World Bank Russia Office (2003), www.worldbank.org.ru

However, according to estimates of World Bank Russia Office, even in the most favourable environment, with oil price at 23 USD/bbl and continued reform implementation, Russia would require a 17% increase in fixed capital investment annually to grow at 5.2% on average from 2002 to 2010. Without continued reform implementation but with continued high oil prices, capital investment grows much lower, at 8.1% on average, and average growth will not exceed 2.5%.

To sum up - the results indicate that Russia’s growth is driven by the quality of reform implementation rather than natural resource prices. Long term growth rates substantially above 5% appear unlikely to materialize in the immediate future and will require investment flows of an exceptional order of magnitude, which can only be realized if reforms succeed in reversing capital outflows and Russia’s current negative foreign investment position. The key areas of reform are thus measures to improve the investment environment and to allow for the return of Russian capital. **Successful reforms** - imposing hard budget constraints on communities, enterprises and natural monopolies, and improving the investment environment - will influence productivity and growth by attracting more capital into investment. If this happens, the economy benefits not only from increased volume of investment but productivity growth will accelerate because of the quality improvements associated with this new investment.

Therefore, if we consider that the factors, that have negative impact on dynamics of majority macroeconomic indicators, cannot be outweigh at present by, so-called, ‘the increase factors’ implemented in Russian economy after crisis in 1998, the situation does not seems to be so dramatic. It means than that thus economic growth, *nota bene* bringing cumulative post-crisis growth to more than 39% in 2004, results in large part from adaptation of Russian enterprises to market economy stimulated by actions and measurements taken by Governments (reforms) and changes in monetary policy of Central Bank. Part of these undertakings has long-term character and will have influence on economic development also in future. What means further - Russia is well positioned for further growth and to be **competitive trade partner.**

2.2 Russia’s Opening-Up for Trade

For Russia and CIS countries the challenge of transformation includes the necessity to open up for trade and international investment (WELFENS 1999). Considering the huge size of Russia, its economy is rather open (compared e.g. with the US). But from the point of view of its GDP, it is clear that the country is not open as it could be. If we consider the number of enterprises involved in foreign trade, technical protection or customs process and duties, Russia is still not open economy.

Generally, foreign trade policy is divided on **export substitution** or **import substitution** kinds of policies. The export substitution policy is based on the expansion production of exported good of the country, which leads to the aggravation of trade conditions in favour of trade partners. The import substitution policy may expand the country’s import of good, which lead to the improvement of trade conditions in the country toward trade partners. As a result, the better trade conditions appear in the country, and they become worse for trade partners. The investment stimulation into import substitution policy promotes the domestic production, decreases relative import prices, and rises the relative export prices.

The foreign trade policy in transition countries is mainly focused on providing growth of export products in the foreign markets, improvement the access of these goods to convertible-currency markets, increasing the share of competitive products in total volume of export, stimulating the increase of export revenues. Studies support the export-enhancing policy, but emphasize difficulties in implementation it in practice.

The theory of trade policy states that the government can use different **instruments of trade regulation**: tariffs, quotas, subsidies, and duties. The negative role of import tariffs is shown in the drop of world trade, in the increase of tax burden for customers, in the blast of country's export, in the reduction of total level of employment. The positive side of protective tariffs or non-tariff e.g. quantitative bans/restrictions regarding specific industries is that they protect infant industry, stimulate domestic production and are significant source of budget incomes. Although most of experts agree that the protection of domestic market from undesirable imports and lowering competitiveness of imported goods strengthen the country's trade position, some of them regard this expedient convenient only in a short run. In their opinion the protection of infant industries is suggested in the initial stages of development, because after the period of protection, industries become competitive and assistance is no longer needed. These measures correspond to the need to develop a policy to sustain competitive advantages.

The traditional **trade theories of comparative advantages**, production costs, provided the choice of domestic goods production instead of purchase of foreign goods on the basis of comparing competitive advantages. The basic approach regards **FDI** and trade complements, other is to consider FDI a substitute for trade. Some authors point out that local market oriented FDI has both trade substituting and trade promoting effects. Therefore, the reorientation toward export substitution policy should be directed mainly to export orientation activity of enterprises in highly technology branches with FDI. In countries, which are less successful in acquiring FDI in early stage of transition, and rely on Western Europe's outward processing trade, the large proportion of exports is provided by unskilled labour-intensive products (Mc GETTIGAN 2002). This situation we can observe in Russia, where the main distinguished features of Russian export is resource specialization, which can be explained owing to the low competitiveness of domestic goods, inefficient policy of export stimulating, decreasing share if finished articles in total export value. According Eurostat data, the Russian share in the world foreign trade is not significant, in 2003 Russia's exports share of total world exports was 2.3%, whereas import only 0.9% of total world imports (EUROSTAT 2004). Moreover, the barter, especially with CIS countries, negatively affects on relative prices and development financial, banking sectors.

However, the later experience of Central European countries shows that firms with foreign participation are more trade-intensive on average than domestic companies. Some sectors have become more export or trade-oriented as a result of the activity of enterprises with foreign capital. The structure of export changes from being dominated by raw resource and low-cost labour-intensive products in favour of capital-intensive and skill-intensive products, as it happened in transition countries. The investment in production of capital-intensive and skill-intensive products stimulates economic growth in production sector of economy (WELFENS 2002).

The direction of change in trade composition toward capital intensive and technology-intensive exports may lead to Russian's increased participation in the international division of labour. The more an economy will be open in terms of exports relative to GDP, the easier it will be for country to generate foreign exchange earnings and service external debt payments (WELFENS 1999).

The government already recognizes the necessity of strengthening the manufacturing sector in order to achieve self-sustaining growth, as well as the need for further reform and restructuring to lower obstacles for Small and Medium Enterprises and reduce the burden of taxation. Furthermore, acknowledged also that the goal it has set for economic growth can only be met by means of accelerated reform and restructuring (GLOBAL INSIGHT 2004). Most of the reforms were launched, but this did not yet guarantee a significant influence on Russia's economy. Russia is still behind many East European countries with the implementation of reform (GAVRILENKOV 2004).

The main barrier, however, in opening up, is Russia's tariffs and non- tariffs in trade policy (broad selection in **Appendix 2**). For example, the incomes from **custom duties** make up approx. 3.4% GDP in Russia. The Russian structure of state incomes from custom duties distinguishes from majority of countries. Three fourth of state incomes forms via the export tariff and one fourth-the import duties. The producer's subsidies are considered more favourable method of import restriction in comparison with tariffs and quotas, because they bring smaller losses for national economy.

Therefore, a first step of economic opening up should be elimination or transfer of tariffs and quantities restrictions on the import and export side into tariffs that are more efficient and have less negative welfare effects. **Temporary tariff** protection will give manufacturing industry more breathing space to prepare for full competition. Other experts suggest to set up the **stepped custom duties**, which should reflect the difference in the world and economic prices, because the absence of import duties results in the budget and custom losses. There are also arguments in favour of **uniform tariffs**. Tariff revenues could generate considerable government revenues in the medium term although it seems appropriate to reduce tariff rates in the long run.

As it is commonly known, the **elimination of trade barriers** and development trade liberalization may bring access to FDI. Government policy of economic openness, dismantling of import and export barriers, foreign trade and FDI liberalization promote adjustment of domestic prices to world market prices. It results in decreasing prices on some domestic goods in case of saturation of their internal market, simultaneously increase of competitiveness of goods (NOSOVA 2000). Market determines necessity and profitability of production goods. The competition policy is the basis for creation and preservation industrial structure in economy in future. Searches of new kinds of competitive products, new markets, and production of new commodities force the competition among producers, affects the production costs reduction, and rise export revenues. So overall, the **opening of Russia** may help to increase the productivity of Russia's companies by expanding markets, modernizing equipment, and providing information. This may lead then to diversification of the production and export structure of the Russian economy towards value-added manufactured goods (SAMSON 2002). Consequently, it expands the possibility of access to the world markets of competitive goods and finished articles, strengthens the competition and improves the balance of payments. The most reasonable way to achieving higher growth rates is to lower the entry barriers for businesses and to establish a better business climate aimed at reducing capital flight and attracting foreign capital, and thus rebuilding capital stock across the economy. Further, real appreciation should be also restrained. It is very important to emphasise that maintenance of the real exchange rate at an advantageous level does not only serve for short-term stimulation of exports, but also for winning longer-term confidence of potential investors in a wide range o manufacturing industries whose competitiveness can be maintained on significant export markets. Nevertheless the creation of a good investment climate requires much more than maintenance of a favourable real exchange rate. Further deep reforms of the economy-improving laws and their enforcement in such varied fields as taxation and the protection of property rights, developing the banking system and other institutions of financial intermediation, streamlining regional in the operation of markets, etc.- are also required (NOSOVA 2000).

There is also another reason why Russia has to change its import and export tariffs. The main directions of Russian future **membership to the World Trade Organization (WTO)**, which is for Russia nowadays the priority, are: the real foreign trade liberalization, free access to the European markets of high technologies, improvement tax, custom legislation, and infrastructure development. Russia first applied for accession to the GATT in 1993. The pace depends on negotiations and Russia's ability to implement the necessary reforms of its economic and trade systems to make them compatible with WTO rules, and to offer a commercially significant package of market access commitments in the fields of industrial goods, services and agriculture.

The WTO members apply the rigid tariff restrictions for protection their domestic markets, for example the progressive increase of import tariffs adequate to the degree of processing of imported products. The economic restructuring is the basis for the future progressive development, and a condition for becoming Russia the member of WTO. The Russian membership in WTO will benefit to the most favourable trade regime for these countries, provide an access to the world mechanism for concluding the international transactions. The basic obstacles for foreign trade development in Russia, in the opinion of WTO, are the exchange rate regulation, which is directed at the necessity of getting licences on imported capital. The custom regulations are not stable, and not attractive for foreign investors. Foreign trade tax system does not affect producers in effective way, and stimulate tax collection. The procedure of getting product’s certificate is complicated. There is no mechanism of protection internal market against low quality products.

However, progress has already been made, for example in the area of negotiations on industrial tariffs or of the adoption of new legislation covering Intellectual Property Rights, but more efforts are needed in other areas, such as services, to ensure that they also reach a level commensurate with the rights and obligations of existing WTO Members. Russia signed the **“Treaty on Economic Co-operation for 1998-2007”** 27 February 1998, which is directed to unify tariff and tax policies, and to expand trade relations. Russian government reduced the maximum tariff rate from 30 to 20 per cent on some consumer goods in 1998 and later (**Appendix 2**), but nevertheless considerable differences exist between Russia and WTO members.

The European Union, as Russia’s main trade partner, also recognises Russia's accession to WTO as a priority and sees the fundamental role that membership of the WTO can play in anchoring and solidifying Russia's economic reforms. Russia and the EU have come close to compromise in the talks on Russia’s accession to the WTO, but it is too early to speak about the final agreement on several outstanding issues. The fact is that a number of difficult issues remain. The EU wanted Russia to cut import tariffs on airplanes and cars and allow European finance firms to operate in the country. Russia and the EU still disagree on issues related to the natural gas market – domestic gas prices in Russia are lower than the costs. The price offered to European buyers is four to five times higher than to Russians, therefore, the EU has demanded that Russia raise its domestic gas prices to the international level (Prime-TASS new agency 2004). The Commission was also negotiating to gain access to the transit of gas across Russia and to get export duties reduced (GAZETA.RU 2004). There is a range of questions on tariffs and subsidies. Very sensitive issue at the negotiations is also the regulation of foreign banks' activities in Russia.

Moreover, ratification by Russia the Kyoto Protocol on prevention of global warming is closely linked to WTO negotiations (GATEWAY 2004). A total of 120 countries have already signed the Kyoto Protocol, but only 32 have ratified it, and according to the terms of the agreement it could not enter into force without the signature of either Russia or the United States. On the last day of September, the Russian government recommended that the Duma ratify the Kyoto Protocol to limit greenhouse gas emissions. Russia's opinion concerning a ratification of the Kyoto Protocol was negative stating that it may ruin the Russian economy. However, President Putin insisted on ratification, thus putting an end to years of discussion about whether the Protocol would help or hurt Russia. The EU claims that ratification of the protocol will not threaten the country's economic development. Moreover, it may significantly improves its reputation in the eyes of Western investors. What is also important by ratifying the document, Russia itself will have more weight to throw around in the next stage of negotiations coming in the next couple years (EXPERT 2004).

The EU considers that its positions are reasonable in the light of the obligations Russia will undertake as a WTO Member. They take account of the future perspectives for a deepening relationship between the EU and Russia in the context of a Common European Economic Space and of the rights and commercial opportunities that Russia will get from all other WTO Members as a result of accession. Advantages stemming from Russia's accession to the WTO will be reciprocal. It will provide more stability and predictability, and better terms of access for EU businesses willing to export or establish in Russia. And, on their side, Russian exporters will have guaranteed channels of exports to all markets of WTO members. The EU, therefore, explicitly supports Russia's application for WTO membership.

However, there are also negotiations with the USA and other countries that have to be finished. Many analysts are certain that Russia won't join the WTO in the next three years. The most mentioned year that Russia may join the organization is 2007 (EKHO MOSKWY 2004).

With WTO accession is also connected also issue of granting Russia **full market economy status**. Under the Joint Statement of the EU-Russia Summit of 29 May 2002, the European Union announced Russia market economy status. Russia was the first country to be transferred from the non-market to the transition economy category (July 1998), and is the first again to be transferred from the transition to the market economy category. Not even China (who is a WTO Member) has been transferred from the transition to the market category.

With the classification of RF as a market economy, the EU meets a Russian request that had a political and a trade dimension. From a political point of view, the Russian side wanted to be considered on an equal footing with other major economies and to be recognised as a market economy following Russia's significant efforts to reform its economy. From the point of view of trade, anti-dumping investigations will be based on own data from Russian companies while previously data from other countries were used. This ensures enhanced transparency and in many cases it will lead also to lower dumping margins.

The EU announced market economy status for Russia before the USA. The EU decision was taken entirely on the merits: i.e., as soon as the minimum necessary reforms in the Russian economic and legal structures have taken place. Russian exporters should appreciate that they will be treated in the same way as exporters in other market economies, and that they have the obligation to comply with all the rules which apply - not more and not less. This includes the possibility that the EU will adjust costs or prices which are distorted by the lack of a functioning market. Furthermore, it should be underlined that the recognition of Russia as a market economy should facilitate the process of Russia's accession to the WTO.

Recognition of Russia as a market economy underlines the substantial progress in economic reforms by Russia, and such reforms are a precondition for WTO accession. Therefore, such recognition should facilitate the process of Russia's accession to the WTO, which is staunchly supported by the EU.

3. EU-Russian Bilateral Economic Relationship

Russia is already integrating its economy with the EU. The EU-15 represented Russia's largest trade partner, accounting for 61% of Russia's imports and 61.9% of its export trade in 2003(THE EC DELEGATION IN RUSSIA, 2004). It should increase almost to 60% after EU Eastern Enlargement. Total EU trade with Russia in 2003 amounted to 85 billion euro and the EU had a trade deficit of around -20 billion euro. Russian exports to the EU consist mainly of fuel: it provides 15% of the EU's fuel import needs (EUROPEAN COMISSION 2003). Imports from the EU to Russia include a large share of manufactured goods. Some of the main imported items are machinery and equipment (20% of the total), food (13%), electric and telecom devices (10%), wood and furniture (7%) and cars (6%).

The EU's trade relations with the Russian Federation are based on the **Partnership and Cooperation Agreement (PCA)**, signed in 1994 and entered into force after national ratifications on 1st December 1997. The agreement regulates the political, economic and cultural relations between the EU and Russia and is the legal basis for bilateral trade. One of its main objectives is the promotion of trade and investment as well as the development of harmonious economic relations between the Parties. The EU-Russia Partnership and Co-operation Agreement (PCA) extended to the ten new Member States joining the EU on May 1, 2004. It means that it replaced existing pacts which covered ties of Russia with candidate states. As regards economic relations, the PCA includes provisions on (EUROPEAN COMISSION 2003):

- **Most Favoured Nation (MFN)**. The EU extends to Russia MFN Treatment. Therefore, Russia receives the same treatment as if it were already a member of the World Trade Organisation (WTO). Equally, Russia extends MFN treatment to the EU.
- There is a special regime for trade in steel and nuclear materials in the PCA.
- **Freedom of establishment**. The PCA facilitates the establishment of production and services businesses in certain specified sectors in Russia and in the EU. The EU's and Russian companies are free to establish at least on a national most favoured nation basis, i.e. no worse than the conditions applied to any third country. Once established, the EU and Russian companies are free to operate on a national treatment basis, i.e. as if they were national companies.
- **Approximation of legislation**. Russia has committed itself to approximate its legislation with that of the Community. Some of the areas where it intends to align its laws with the EU's are standards and certification, competition law, company law, banking law, company accounts and taxes, financial services, rules of public procurement, customs law.
- There are further provisions on Intellectual Property Rights (IPR) and trade defence instruments.

- Implementation of the PCA, is being carried out by means of meetings of the institutions created by the agreement: EU/Russia Summit, Cooperation Council (ministerial level), Cooperation Committee (senior official level), Sub-Committees on technical issues.

As provided by the Amsterdam Treaty, **the EU Council adopted in June 1999 a Common Strategy on Russia**, with the aim to strengthen the strategic partnership between Russia and the EU, giving it a horizon extending far into the next century. On its side, Russia also adopted a strategy towards the EU proving the mutual interest of both the EU and Russia in a special relationship. The EU's Common Strategy on Russia combines Member States' and European Community policies and actions in the priority areas of: consolidation of democracy, rule of law and public institutions; integration of Russia into a common European economic and social space; stability and security in Europe and beyond; common challenges on the European continent (environment, crime). The PCA, TACIS and Member States' assistance programmes are the main instruments for implementing the Common Strategy.

The EU is the most important assistance donor to Russia. Between 1991 and 2003, Russia received 2.6 billion euro in aid from the EU. The bulk of the aid is allocated via the extensive **TACIS programme** (Technical Assistance to CIS Countries). This programme was initiated in 1991 with a view to contributing technical and economic assistance to the 12 CIS countries during the adjustment process (GOWAN 2000). The primary objective is to support the process of economic and democratic reform, including the promotion of independent media and non-governmental organisations, banking and tax sector reforms as well as social reforms. In recent years, the TACIS programme has developed into a valuable tool for underpinning the political goals formulated in the Partnership and Co-operation Agreement and the EU Common Strategy on Russia. The TACIS Indicative Programme for Russia for the period 2004-06 includes a special package for Kaliningrad, cost at some 25 million euro over these three years and focusing in particular on sectors such as administrative reform and business development, public health, education, and cross-border cooperation.

The EU economic co-operation and political dialogue with Russia take place in many fora. The **Summits** are the most important, and are held twice a year. Similarly, Russian and the EU Foreign Ministers meet at least once a year in the Co-operation Council. Regular meetings take place between the Russian Foreign Minister and the EU troika (EU Presidency, the incoming EU Presidency, the Commission and the Council Secretary-General) and also between a number of expert groups at officials level. Current issues are discussed also in the Parliamentary Co-operation Committee, which includes Members of the European Parliament and the Russian Parliament. At the **14th Summit** between the European Union and Russia, held in The Hague on 25 November 2004 the European Commission represented the High Representative for the EU Common Foreign and Security Policy, Javier Solana, and the President of the European Commission, Jose Manuel Durao Barroso. The Russian delegation was led by the President of the Russian Federation, Vladimir Putin. The leaders of the EU and Russia particularly welcomed that the Kyoto protocol will enter into force in February 2005, following ratification by Russia, and noted that this will provide a solid basis for strengthened bilateral and international cooperation on climate change. This was the second Summit after the EU historic enlargement. Therefore, the extension of the Partnership and Cooperation Agreement to the new EU Member States was welcomed. The leaders of the Summit reviewed the steps taken to address the impact of EU Eastern Enlargement on EU/Russia relations and stressed their firm commitment to actively continue this work to fulfil the "Joint Statement on EU Enlargement and EU-Russia Relations" of 27 April 2004.

Following the success of the previous summit and the progress achieved in creation of the four 'common spaces' (economic; freedom, security and justice; research, education and culture; and external security), the leaders welcomed the efforts made to put in place the conditions for increased and intensified trade and investment between the EU and Russia. They took note of a progress report on the energy dialogue as well as of the results of the EU-Russia Industrialists Round Table, which took place on 10 November 2004 in The Hague. (THE EC DELEGATION IN RUSSIA, 2004)

What is written above only confirm that the European Union and the Russian Federation have undoubtedly an important trade relationship. The interest of both parties in maintaining and strengthening cooperation and making trade relations more predictable, transparent and open will be even more important because of the EU Enlargement, when they become direct neighbours.

4. Trade Consequences of the EU Eastern Enlargement to Russia

4.1 EU Enlargement – an Opportunity for CEE Countries

Under the **Copenhagen criteria**, membership requires that the candidate country ensures:

- "stability of institutions guaranteeing democracy, the rule of law, human rights and the respect for and protection of minorities"- the **political criteria**
- "the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union" – the **economic criteria.**
- "ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union" – **acquis communautaire.**

The economic criteria consist of two elements:

- the existence of a functioning market economy - it requires macroeconomic stability and that prices, as well trade, are liberalized and that an enforceable legal system, including property rights, is in place; a well-developed financial sector, the absence of any significant barriers to market entry and exit improve the efficiency of the economy; it also requires a sufficient amount of human and physical capital.
- the capacity to withstand competitive pressure and market forces within the Union.

Beyond the EU membership criteria, there are the **Maastricht criteria,** which are even stronger because they define the macroeconomic convergence which is needed for entering the single currency area of the euro.

Those candidates who fulfilled these requirements become EU members.

The historical and political arguments in favour of the EU Eastern Enlargement are compelling. It should produce substantial economic benefits. As of the day of accession, the new member states apply the EU's Common Commercial Policy in its entirety, including the Common External Tariff, EU preferential trade agreements, WTO commitments and EU trade defence measures. They also adopt internal market rules and benefit from the four freedoms set out in the Treaty. Full integration with accession, together with the adoption of common rules and standards across the world's largest single market, will further enhance the opportunities to achieve socially and environmentally sustainable growth.

The **static theory of customs unions** ignores the many dynamic effects of customs unions and other forms of economic integration on economic growth. An economic integration can promote economic welfare not only by inducing higher efficiency but also by stimulating growth. Indeed, the impact of its dynamic effects on world welfare may well overwhelm any negative static effects. The most obvious consequences is market extension – of producers and consumers.

A key academic study by the Centre for Economic Policy Research estimated already in 1997 that trade and investment, both within the enlarged Union and with EU's external partners, will greatly benefit from an extra 105 million consumers and a 34% increase in area as the result of the fifth Enlargement. In fact, the new member- countries became part of the **EU Single Market, that is the largest in the world** with a population of almost 455 Million people, GDP of around 9231 billion euro, 19% of world trade, 46% of world outward FDI and 24% of inward FDI and with a high degree of openness. Free movement of goods, services, labour and capital with internal barriers being removed (border controls, certification, etc.) and a common border protection. What means that some new members' links with their neighbours in the former Soviet Union should enable EU-based firms to engage in increased trade and investment in the new Member States. Developing countries, enjoying preferential access to the EU, should find new markets in the acceding countries and new members may also improve their access to the markets of developing countries through economic and trade co-operation.

What will accession of the CEE countries mean for Russia which, in fact, was the second partner of the ten acceding countries, behind the EU but ahead of the US, Japan or China?

4.2 EU Enlargement and Russia

"Russia is best placed to benefit from EU Enlargement" Ms Francoise Le Bail, Director for Russia, DG Trade (THE EC DELEGATION IN RUSSIA 2003). Based on the EC's **analyses, the EU Enlargement** should be also **beneficial for EU-Russia relations** and Russia's trade in the long run, mostly through (EUROPEAN COMISSION 2002):

- the advantages of having a **zone of peace**, stability and prosperity as a neighbour
- introduction of **EU tariffs** in the CEE countries, because the EU tariffs are much lower than those which were in force in the CEE countries (for example Poland, which used to have the highest tariffs amongst the acceding countries, had to reduce her tariffs for imported Russian manufacturing goods from 15.8% to 4.1%).
- for **trade in goods** the new member states had to adopt the **Community Common Customs Tariff (CCT)** upon accession. The average weighted industrial tariffs of the acceding countries were in general higher than the 3.6% average for the EU; the same applies to agricultural tariffs. Thus, in most cases, third countries' business should benefit from lower tariffs in their trade with new member states.
- extension of the common Community trade regime and **single market rules.** Indeed, not only a single tariff, but also a single set of trade rules and a single set of administrative procedures applied across the Single Market of the enlarged Union.

The current system, featuring a single trade regime for the EU and a different regime for each of the candidates, disappeared. A single set of trade rules, a single tariff, and a single set of administrative procedures applied not just across the existing fifteen member states but across the enlarged Union of twenty-five. This should greatly simplifies dealings for third-country operators within Europe, thus facilitating investment and trade.

- the releasing of financial problems- **better credit possibilities**, export credit insurance system in the CEE countries that will get inside the EU-might have a positive effect on trade relation between Russia and East-Europe.

Recent macro-economic studies by CEPS (Centre for European Policy Studies) and the RECEP (Russian European Centre for Economic Policy) have concluded that the effects of the EU Enlargement will be positive for the Russian economy. They estimate that Russian welfare will increase as a result of the Enlargement by around 2%, with Russia's GDP, exports and its terms of trade also should improve. The study by CEPS estimates in particular that Russian exports to the enlarged EU will go up by around 4% to the current EU-15, and by more than 1% to the ten new Member States.

Though Russia would gain certain advantages by the expansion, these advantages might be less as compared to the **disadvantages** deriving from her outside position. The point from Russian side is not simply the fact that expansion was going without her participation, but the situation according to which Russia is staying outdoor of EU, whereas new members take full advantages of market liberalization. As the result the EU market opening for new members should strengthen competitiveness of products of the EU new member states on the EU market (**Appendix 1**). There are such worries as: application of new non-tariff barriers to trade, **trade diversion** because of an increased productivity gap with the CEE countries, **diversion of investment** from Russia to the new EU members, infrastructure problems, deterioration of conditions for the transit of goods, including the problem of transit between Kaliningrad and the rest of Russia. Considering these effects, it may create the most serious consequences for Russian economic interest, therefore, I would like to introduce them closer and give the EU view on al these Russia's concerns.

4.2.1 Relations with CEE Countries

Russian experts assume a likely deterioration in trade and the economic regime for Russia in its relations with the CEE countries after their accession to the EU. This can be due to the fact, that in the past few years the group of East-Europe countries, which joined EU during the Eastern Enlargement, had accounting for the biggest share in the turnover of Russia (22% of Russia's export and 8% of imports).

Russia had feared losing trade benefits with the new EU member states, mostly former Soviet satellites, by adopting by them EU tariffs and standards. However, this case will be presented further, here I would like to focus on other issue – second site of coin.

These countries are not only the biggest markets for Russia products in the region, but the rate of growth in the trade with these countries exceed that of total Russian foreign trade and trade with East Europe itself regarding both exports and imports. As according to the **theory of trade creation**, the market access of goods will be presumably improving for the East European producers after joining to the EU, it may causes even worsening market access for Russian sellers on the enlarged EU-market. Going into the detail, the biggest competitors for Russia companies in the EU market may come from among these countries as a result of formulating within EU the trade area (**theory of trade diversion**). From among the main EU import products or product group, in which Russian sales are significant, Czech, Polish and Latvian sellers are the biggest rivals to Russian's in the case of wood products. On the market of iron and steel products Czech, Poland, Slovakia and Romania can be found among her biggest rivals. Hungary's joining seems to be the most indifferent for Russia from purely economic point view. Hungary represents a relatively small market, moreover, Hungarian and Russian sellers on the EU-markets are in most cases not rivals to each other having in mind the most important import products of the EU. The participation of Slovenia and Estonia will create probably even less impacts on Russian economic interests due to their small size and marginal role played in Russian foreign trade turnover.

The signing of free trade area agreements with the CEE countries - or some of them- would be the way of releasing Russia's problems in this case. However, the main obstacle to this is, that the associated CEE countries consider all of their foreign trade policy decisions in the light of their EU-joining. Due to this they are not willing to sign free trade or other special agreements with those countries that have no similar agreement with the EU itself

As for Russian investment opportunities they will probably be adversely affected by the EU Enlargement since it will certainly increase the already existing competitive edge of the CEE countries on the world and European financial markets. The EU, however assumes that it is still unclear whether accession to the EU will result also in a considerable **diversion of the CEE countries trade** from Russia to Western Europe and vice versa. Logically, trade diversion should be insignificant because the commercial ties between the two sides had collapsed much earlier and the existing level of trade is too low to diminish any further.

Already during the period of the gradual implementation of the Europe-agreements Russian products had to face more and more disadvantageous situation on the EU-markets. Paying attention to the recent priorities of Russian foreign trade policy such as stimulating the production of manufacturing goods, the deterioration of trade conditions for Russia sales is of vital significance. It is so even if the major part of Russian exports to both the EU and CEE countries consists of raw materials, especially energy carriers- both on the EU-markets, but in a bigger extent on the CEE countries markets. This is the argument of the EU, when it says that the creation of a free trade area between the EU and the associated members should not have any considerable effect on Russian interests, since raw materials and low-processed products are subjected to minimum customs taxation if any.

4.2.2 Tariffs and Non-Tariffs Barriers

After the EU Enlargement, 51 per cent of Russia's trade is with the EU. Therefore, one of the possible concerns is the effect of the Community **tariffs being adopted by the candidate countries**. Russia had complained that the introduction of common EU trade tariffs in the new member states would cost it 300 million USD a year. However, the overall level of tariff protection in the EU decreased after Enlargement. The current average tariff in the EU is around 4% while the average tariff in the 10 acceding countries (ACs) was around 9%. For example:

		ACs	EU
Steel products	Poland:	10.3%	1.7%
Cars and trucks	Czech Rep	7.1%	4.6%
Meat products	Hungary:	28.8%	21.8%

Source: European Commission, DG Trade (2003)

So as Polish, Czech, Hungarian tariffs came down, Russia should benefit also in **agriculture**, for the following reasons:

- safeguard measures or quotas applied by acceding countries on agricultural products are lifted (e.g. Czech Republic on sugar, Poland on goose eggs, etc.). The EU does not apply any safeguard measures on agriculture products.
- certain products that were being exported to Russia from acceding countries with export support in these countries no longer benefit from this support under the EU system (e.g. pork meat from Poland).

The truth is also that some tariffs went up, but the benefits in terms of overall tariff protection in the ten new Member States after the EU Enlargement should outweigh any negative effects in specific products for Russia.

At closer analysis it appears to be quite favourable - the Common External Tariff of the EU, which applied by acceding countries, as was said above, is on average lower than national tariffs previously applied. Moreover, there is also such possibility that Russia and the EU may sign an agreement on the EU Enlargement according to which, Russia will receive compensation if, due to the enlargement, the duty on specific goods increases. The compensation will be provided according to the rules of the World Trade Organization.

More complicated may seem to be the implementation of **non-tariff barriers (especially quantitative restrictions**). Russia was afraid that some new EU members, having introduced the common EU restrictions, might in addition retain their existing national practices of market protection. However, acceding countries had to apply the common trade regime without exceptions. If they did not, it is obvious that the single market could not function. The EU-Russia Partnership and Cooperation Agreement that was also adopted by acceding countries, ended the use of quantitative restrictions between the EU and Russia. However, there are still some sectors where the European Union maintains some limited quantitative restrictions with third countries, notably in the cases of textiles and steel. Indeed the new member states had to apply these restrictions as of their accession, but the effect on third countries will be limited. The WTO rules foresee that all textiles and clothing quotas shall be phased out by 31 December 2004. As far as steel is concerned, the two EC agreements which foresee quotas run until 31 December 2004 and would disappear if the countries concerned joined the WTO before then. Moreover, what is important, upon accession to the EU, new Member had to remove all quantitative restrictions currently applied, i.e. Hungary on textile products, Poland on coal.

Next point of concerns: Russia is afraid that its exports of **energy products** to the enlarged EU will decrease as a result of the application by acceding countries of the EU’s trade regime for energy products. Francoise Le Bail, Director for Russia, DG Trade stated that this will not be the case. First, the EU's tariffs for energy products are lower than those of certain new Member States. Furthermore, the EU has never applied any tariffs on imports of fuel, gas or electricity. Secondly, on trade in nuclear materials, at the most recent Summits, EU and Russia have agreed to reach a mutually acceptable solution, again in the context of the EU Eastern Enlargement and the need to ensure reliable, secure and safe supplies for the enlarged EU. Thirdly, the EU has recently agreed to deregulate and liberalise its energy market for gas by 2007, which will create new opportunities for Russian exporters. Therefore, Russia is and will continue to be a major supplier of energy products to the enlarged EU.The EU has the **Trade Barriers Regulation (TBR**), the Community's offensive commercial policy instrument, which gives industry the opportunity to lodge a complaint with the Commission when there is reason to believe that companies are encountering trade barriers that restrict their access to third country markets. The EU has also two main **Trade Defence Instruments (TDI)** at its disposal to ensure fair trade: **anti-dumping** and **anti-subsidy measures.** Russian exporters may, therefore, encounter supplementary difficulties as a result of EU competition policy being adopted by the candidate countries. Particularly sensitive may be the extension of the standing anti-dumping procedures, or of the unilateral obligations taken by Russian firms with regard to existing EU markets. Therefore, by the moment **antidumping procedures** affecting Russian exports seems to be the most awkward question between the Russia and the EU. As of 31 December 2001, the Community had 11 definitive and no provisional anti-dumping measures in force against Russia. Undertakings had been accepted in 5 out of these 11 cases. The value of imports covered by measures in 2001 was 167 million euro, representing 1.3% of total imports from Russia. The value of anti-dumping duties declared on Russian products in 2001 was under 20 million euro, meaning that the average duty imposed was in the region of 12%. As of 30 September 2002, the Community had anti-dumping measures on imports of 12 products from Russia (5 of which are covered by undertakings). The value of imports covered by measures during the first half of 2002 was 93 million euro (1.5% of imports). However, the amount of anti-dumping duties declared was 3.4 million euro, i.e. an average duty of less than 4% (EUROPEAN COMISSION 2004). The EC argues that the new anti-dumping (AD) rules adopted by acceding countries absolutely will not create further barriers for the access of Russian exports to the European market. The EU legislation and procedure are in line with applicable WTO and other international agreements on unfair trading practices and the purpose of AD rules is not to create barriers to trade, but rather to provide a fair, level playing field by fighting unfair trade practices. Therefore, the EU will continue to make use of trade defence instruments as it has until now, that is with prudence and moderation, as well as in full accordance with WTO legislation. However, as clearly recognized by Russia, the Russian energy market has not yet been liberalized (although this is the goal). This implies that energy prices in Russia are still subject to state regulation of prices and are not subject to market forces and thus out of line with the true full costs of energy (i.e. with natural advantages). This is further underlined by the existence of dual pricing. In these circumstances WTO rules allow adjustments to be made to energy prices in the calculation of dumping margins.

By definition, market economies are automatically subject to anti-subsidy rules, as defined by the WTO. General WTO principles are also in EU law. It is EU policy to apply WTO-plus rules to all third countries, regardless of whether they are WTO members or not. Moreover, "there appears to be a misunderstanding of basic concepts on the part of certain Russian exporters, because the AD instrument is not aimed at natural or competitive advantages. Prices which are "cheap" because they do not reflect true costs (for example because prices are set by the State) can be adjusted. This is logical and has nothing to do with true advantages"

The WTO rules on compensation do not concern the application of anti-dumping measures since such measures can be imposed notwithstanding the provisions concerning bound duty rates. Nonetheless, as was done for the last the EU Enlargement, the Commission may in specific cases carry out reviews on request to examine if the anti-dumping measures would have been significantly different if they were based on information including new Member States. So like for the last enlargement, the EU will be prepared to receive requests from exporters if they can show that circumstances with regard to a case have changed substantially due to enlargement. And again, the new Member States ceased to apply any measures were in force against Russian imports i.e. Polish measures on calcium carbide, for Lithuanian measures on quicklime and portland cement, for Czech measures on welded tubes and pipes, etc, and for measures by several new member countries on Russian ammonium nitrate. Thus, Russian exports of some of these particular products are likely to increase after Enlargement.

As to other trade defence measures – **export subsidies**, the new Member States also automatically applied the EU acquis in this field, including whatever measures are in force at that moment. However, the EU is continuing to reduce, substantially, use of export subsidies by 45% in value.

4.2.3 The EU's Standards

Another point of concerns is that Russian exports of manufactured goods may be put under pressure by the shift from national standards and certification procedures in the CEE countries, which were generally of COMECON origin, to those of the EU. Needless to say that the new standards, particularly in those areas where **certification** is mandatory, will be rather difficult to master in view of the notoriously low competitiveness of Russian industry. However, the application of certification rules and the extension of the same standards, such as **phytosanitary procedures, environmental protection standards,** etc., for all new Member States should simplify the activity of Russian operators in the single market as they will have to comply with just one set of rules.

4.2.4 Other Economic Issues

It is rather difficult to predict the effects of the imminent **change-over to the euro** in Central and Eastern Europe. Trade, where the currency is nothing more than a neutral vehicle, is likely to follow its own course and the introduction of the euro will hardly create any specific problems. The US dollar will certainly retain its position unless there is a major shift in the international energy and raw materials markets. More consequential may be the eventual **conversion of Russian long-term assets** and liabilities in the CEE countries. However, the material effects of such a conversion are not to be exaggerated. Most of experts argue also, that in any case the process will be market-driven rather than government-negotiated, and there is very little that could be done by either side.

The accession of countries of Central and Eastern Europe to the EU may improve the conditions of Russian commodity **transit to Western Europe**, which is not infrequently subject to arbitrary actions of the candidate countries. Nonetheless this issue, which is of paramount importance for both Russia and its European partners, will have to be carefully regularized in conformity with the new conditions. One of the major problems is safeguarding an unhampered movement of goods between the **Kaliningrad enclave** and the rest of Russia. In the course of the debate many questions were raised about the situation in the *Oblast* and how it affects neighbouring countries, the real interests and intentions of the parties involved in the debate, and the future of the region.

4.2.5 Kaliningrad and EU Enlargement: a Border or a Barrier?

The focal point of all long-term complications brought about by the EU Enlargement is the fate of the Kaliningrad enclave. Kaliningrad is a unique part of Russia, separated geographically from the rest of the country and **surrounded by the EU**.

In the EU's opinion Russia's regions should benefit substantially from the Enlargement, especially Kaliningrad, which is well placed to take advantages of the new opportunities that will be created. As was already mentioned in the paper, Russian goods should benefit from significantly lower tariffs after the Enlargement and these lower tariff levels applied to goods originating in Kaliningrad on the same basis as the rest of Russia. Given its proximity to the EU markets this prospect of easier access represents an important opportunity for Kaliningrad. Since Kaliningrad relies strongly on trade with neighbouring areas, it should have an interest in adopting EU technical norms and standards to enable it to take full benefit from this improved market access. However, until a more detailed assessment is done, it cannot be excluded that the changes in the trade regime which will take place on accession might have an impact on particular products (CENTRE FOR EASTERN STUDIES 2001).

Responsibility for Kaliningrad lies with Russia and the region itself. However, the EU and its Member States have an interest in helping to ensure that the changes required by accession are made smoothly and in fostering co-operation with Kaliningrad on a number of regional issues. There are several documents approved by the relevant institutions of the EU and Russia. The first document on Russia's concerns inspired by the Eastern Enlargement of the European Union was submitted to the Commission in August 1999. A dialogue started more than a year later, in October 2000. From EU's side, there is a communication by the European Commission to the Council entitled **"The EU and Kaliningrad".** From Russia's side, there are so far three Russian documents. One of them is a decision by the Russian government on "Measures for ensuring social and economic development and vitality of Kaliningrad *oblast* ". Two other documents – "Possible solutions to the specific problems of Kaliningrad region in connection with the EU Enlargement" drafted by the Russian Ministry for Trade and Economic Development, and the "In-depth evaluation" of the Commission's communication (BORKO 2002).

It was recently announced that most of Russia's trade concerns related to the EU Enlargement had been resolved, although the arrangements for goods transit between Russia and its Kaliningrad "exclave" were still at issue, and a Joint Statement linked to the PCA extension was still to be agreed.

Issues arising from the enlargement process, which appear on Russian side, are namely: the movement of goods and people between Kaliningrad and the rest of Russia, including visa regime, energy supply of the region, trans-border cooperation and fisheries. One aspect of movement of goods that requires attention is **border crossings.** However, experience of the last enlargement has demonstrated that the introduction of the *acquis* on the border between Finland and Russia can speed up border crossing formalities. It should be possible to build on this positive experience and to use some of the funds available through the PHARE and TACIS programmes to finance improvements in border crossing facilities and procedures, in close co-operation with the Russian authorities.

The introduction of the acquis by new Member States have an impact on third countries in terms of **visa requirements** and border controls. Travel, for whatever purpose, to or through EU Member States requires possession of a visa. Therefore, another problem, which is clearly underestimated, is the impact of EU Enlargement on the **free movement of persons.** The introduction of visas and more rigorous border controls between Russia and the CEE countries became a problem for thousands of people who have become accustomed to unrestricted movement in the area, visiting their relatives and friends, shopping, performing miscellaneous little jobs or carrying out various business activities. This is perhaps the greatest net loss which will be inflicted by the EU Enlargement on the citizens of Russia and the CEE countries (CENTRE FOR EASTERN STUDIES 2002).

As far as concrete decisions are concerned, they depend on the character of the issues to be under consideration. They are seen as special agreements between Russia and the EU (for example, on fisheries or the special visa regime for residents of Kaliningrad), joint decisions (Indicative TACIS programs), or unilateral decisions (participation of European Investment Bank or Regulation for Kaliningrad SEZ), etc. In particular, if at present EU-Russia trade relations are governed by the Partnership and Co-operation Agreement (PCA) signed in 1994 and upon accession Poland and Lithuania took over the PCA as part of the acquis and the common external tariff applied in trade between Russia and the enlarged EU, Russia is interested in concluding the agreements on the Kaliningrad issues also with the participation of the authorities of Poland, Lithuania and Latvia within their national competence (EUROPEAN COMISSION 2002).

In February 2003 in Vilnius a Financing Memorandum, was signed by Minister of Finance Dalia Grybauskaite and Head of the European Commission Delegation Michael Graham, providing Lithuania 12 million euro **financial support for implementing the new system of facilitated transit procedures of Russian citizens through Lithuania to and from Kaliningrad** Region. The project, financed in 100% by the Community, aims to guarantee proper control of transit of passengers between Kaliningrad and other parts of Russia through the introduction of a Facilitated Rail Transit Documents/Facilitated Transit Documents scheme. Moreover, worth mentioning is also fact that Russia, the EU as well as new members involved in this issue started talks with the aim of signing an agreement on Kaliningrad cargo transit started and talks on easing visa regulations.

The potentials of the **“Northern Dimension” programme** and some other frames of regional cooperation have also to be taken into consideration. Lately, the Council has adopted the **Second Northern Dimension Action Plan for the period 2004-2006**. The present document follows the First Action Plan for the Northern Dimension, adopted by the European Council in Feira in June 2000, and expiring at the end of 2003. Plan covers five broad priority sectors

All above mentioned issues connected with the influence of EU Enlargement on Kaliningrad are being assessed by experts in Russia, the CEE countries and the European Union, however, there are different opinions among them. Some of them assume that if the Kaliningrad region retains strong links with Russia, its presence in the midst of integrating EU territories may be an irritating nuisance for the Europeans, particularly if organized crime and corruption remain systemic features of the Russian situation.

The official view, that it is bound to become a major hub of EU-Russian cooperation, is superficial. From time to time, proposals have been made also for **special trade regime** for Kaliningrad. Nevertheless, since Kaliningrad is an integral part of Russia, it might be difficult to grant any special status, such as free trade or a customs union. It is not clear that any special treatment is needed (WSPÓLNOTY EUROPEJSKIE 2001).

From a political point of view, the process of the EU Eastern Enlargement was welcomed by Russia, since it was understood that Russia would have a reliable neighbour on the continent to the west of its borders. However this favourable political climate should be a basis now to new measurement which have to be undertaken to develop closer trade cooperation between Russia and the EU as well as new member states from CEE in order to keep these important export markets for Russia. It is also expected that all the negative effects of the Eastern Enlargement of the EU may be reduced by Russia's joining to the WTO. On the other side Russia will have to make her sacrifice for the membership by further opening up, especially-liberalisation in foreign trade regulation. For Russia it will be definitely difficult situation and dilemma: how to continue successfully the process of opening up when there is such obstacle as the EU Enlargement, which may reduce exports, especially in the manufacturing sector and deteriorate Russia's economy? The issue is now part of Russia's economic strategy.

5. Strengthening the need for building the CEES between the EU and Russia

There are fundamental factors, described already in this paper that must be taken into account when making common economic and trade policy choices for Russia.

- **One** of them is that Russia' economy is faced with the challenge of producing sustained, high rates and economic growth.
- **A second factor** is that Russia has a relatively narrow industrial manufacturing base and economic policy need to be directed toward facilitating the emerge of small and medium-sized industries in the manufacturing and services sector.
- **A third factor** is that the key to durable recovery of the Russian economy lies in opening up for trade, in a return of investors and adoption of reforms.
- **A fourth factor** is connected with EU-Russia economic relationship and **EU trade regime**. Because the EU uses the protection regime for the domestic goods and the export some of technically complicated manufactured articles from Russia to the EU, Russia expects the EU to further liberalize access to its markets for goods and services, on the basis of predictable, transparent, and non-discriminatory rules. The EU point out that is already opening its markets further to developing countries, and is supporting comprehensive efforts to ensure that developing countries enjoy the benefits of multilateral liberalization. However, the EU states also that opening markets – and keeping them open without discrimination must be supported by the application of common rules and a general acceptance that certain types of behaviour are unfair.

Such efforts proceed also in coordination with related initiatives within institutions including the World Trade Organization (WTO), the World Bank and the International Monetary Fund (IMF). For example, the aim of the **WTO Agreement on Technical Barriers to Trade (TBT Agreement)** is to ensure that mandatory technical regulations, voluntary standards, and procedures for assessing conformity with technical regulations and standards that do not create unnecessary obstacles to international trade. It is a useful tool in tackling unnecessary technical barriers to trade. The EU has made the promotion of international standards what helps to reduce unnecessary differences among national conformity assessment procedures. The EU would also like to promote the international harmonization of conformity assessment procedures wherever appropriate. This would help eliminate duplication of efforts and simplify procedures. The EU launched a new **market access strategy** in February 1996. This initiative gave EU trade policy a more proactive stance, in tune with the real needs of European exporters in an increasingly interdependent global economy. Thanks to the market access strategy the Commission has solved more than 150 cases of obstacles to trade in third country markets. It has performed particularly well against high tariffs, technical barriers to trade and burdensome customs procedures. It has focused primarily on barriers with a cross-sectoral effects on trade. But there were also good results in agriculture, automobiles, ferrous and non-ferrous metals, telecoms, textiles and financial services. These results are spread across a wide spectrum of countries which have agreed to dismantle trade barriers after consultations with the EC. The market access strategy has introduced new procedures to strengthen co-ordination between those involved in trade policy in the European Commission, Member States and European businesses. Thus, the strategy has improved the flow of information on specific barriers. It, therefore, contributes to the identification and elimination of barriers. The Commission has now established a standard procedure to identify priority barriers with a view to removing them by:

- making use of the WTO dispute settlement mechanism;
- improving implementation by trading partners of their obligations under bilateral agreements with the EU, including where appropriate, use of the dispute settlements mechanism;
- addressing market access problems during the negotiation of new bilateral agreements (e.g. the free trade areas)
- organizing bilateral consultations targeting major non-WTO issues with key trading partners;
- carrying out bilateral consultations on market access issues with a view to implementing mutually beneficial market access packages;
- **The final factor** relates also to **EU Eastern Enlargement**, its effect on Russia's trade and the following questions: is there any chance that Russia, being a European country, may one day join the European Union as a fully-fledged member, provided it fulfils the Copenhagen criteria? Or, on the contrary, because of its size, geopolitical position, historical and cultural heritage, multi-ethnicity and a host of other reasons, Russia will never become a member of the European Union? These questions are by no means rhetorical. If Russia is to join the European Union sooner or later it has no other option but to follow the path taken by the CEE countries. However, because in the meantime, there is no reasonable prospect of Russia's accession to the EU, Moscow has to look for a strategy that will help her to be at an advantage position after the Enlargement. It would be also desirable that the EU – and the new member countries –not only support the Russian opening-up and integration into the world economy but also actively search for the solutions satisfactory for all parties.

The EU started its internal reflection on the impact of the EU Enlargement on its close neighbours including Russia a long time ago. As shown by the **Wider Europe communication released by the Commission on 11 March 2003.** The European Commission presented the following communication to the European Council and Parliament: "Wider Europe - Neighbourhood: A New Framework for Relations with our Eastern and Southern Neighbours". The "Wider Europe" concept is directed at two regions: the Southern Mediterranean countries, which include Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestine, Syria and Tunisia, as well as former USSR countries Belarus, Moldova, Russia and Ukraine. The lack of membership perspectives as regards the first group has long since been clearly outlined, however, the EU declarations with regard to the second have, hitherto, not been univocal. Including these four countries in the "Wider Europe" initiative clearly shows that the Union does not, at present, see membership perspectives for them (although, as indicated in the communication, the appearance of such perspectives in the future cannot be entirely excluded). It is, therefore, clear that Brussels - even though it does not yet see membership perspectives for a series of present and future neighbours - is interested in tightening co-operation with these countries. However, success within this scope requires the elaboration of a new, uniform concept of a policy directed at countries of geographic proximity with which, at this stage, the EU wishes to build relations without referring to the possibility of their entering the European Union. A model for co-operation, which would create equal opportunities and possibilities of co-operation for all those neighbours of the Union, who do not currently have membership perspectives (CENTRE FOR EASTERN STUDIES 2003).

Russia should also anticipate that the **specific policy priorities of new member-countries** will influence the EU's general policies. Consider, as one example of this, the EU Northern Dimension policy, which was created under the influence of Member States such as Finland and Sweden. According to statements of lately adopted Second Northern Dimension Plan - a favourable business climate must be developed on both sides of the future EU-border through, inter alia, the implementation of economic reforms in the Russia Federation, and Russian efforts to integrate with the international economy (through WTO accession), and with the EU economy (through the Common European Economic Space initiative). Further efforts will be made to remove technical and other barriers to trade and investment, support economic reforms, promote Small and Medium Enterprises (SMEs).

All above mentioned four elements suggest that some important strategic changes will be made in Russia and the EU-Russia relations. The first concerns Russian accession to the World Trade Organisation. The second, which relates to EU-RF trade relations and the EU Enlargement, is based on the creation of a **Common European Economic Space (CEES**) between the EU and Russia.

The building of a CEES will embrace Russia and 25 countries of EU. The Eastern Enlargement of the EU expanded the common borders and common interests of Russia and the EU and thus gave a new impetus for closer co-operation. The EU is Russia's most important trading partner and even more important after EU Enlargement. The EU and Russia agree that the CEES is more than a useful solution for Russia and its trade policy-it is a necessary solution, since the enlarged Union may represent almost 60% of Russian export. Greater integration may bring greater interdependence between the economies and societies of the EU and Russia. The CEES reflects this new situation and may serve as important tool to facilitate further efforts to bring the EU and Russia closer together.

What could the Common European Economic Space be? Where should be located in the scale of all possible forms of integration with the EU? Will it be similar to the European Economic Area of 1992 between EEC and EFTA? What are the main features of this concept?

5.1 Searching for the Form of CEES

The CEES concept should be located somewhere in the scale of all the possible forms of integration within the EU. There are **four grades of partnership between EU and third countries:**

Commercial Agreements

Are at the bottom of the pyramid. They create a **free-trade zone** (other terminology: free trade area, customs zone, export processing zone (EPZ), industrial free zone etc.) for industrial goods (UNITED NATIONS 1990). Building its own free-trade areas - it is a good way for third non- member country, as most of CEE countries did a long time ago, to offset any adversely affects of the completion of the EU single market.

Definitions as to what constitutes an export-processing zone are at least as numerous as the names used to describe this phenomenon. For practical purposes, an EPZ could be defined here as a clearly delineated industrial estate which constitutes a free trade enclave in the customs and trade regime of a country, and where foreign manufacturing firms producing mainly for export benefit from a certain number of fiscal and financial incentives. The modern concept of the export processing zone as a territorial enclave in which foreign firms, benefiting from special incentives, including exemptions from customs duties and preferential treatment with respect to various fiscal and financial regulations and other privileges produce industrial goods for export

There are several considerations which push governments to opt for EPZ regimes (UNITED NATIONS 1992):

- a desire to **increase foreign exchange earnings** and **promote export**. Manufacturing-led economic diversification is now well-established in a number of developing countries which previously depended on the production and export of one or two agricultural or mineral commodities;
- as free trade zone is created to encourage economic initiatives in the manufacture goods, the performance of services, commercial and other activities necessary for diversifying and increasing export. This is a good **investment form,** a financial and economic standpoint. The benefits of such project exceed their anticipated costs by a sufficient margin to allow for an acceptable return on the relatively large investments which are to be undertaken. This, in many countries, has been largely achieved, with multinationals from both industrialized market economy countries and SMEs from dynamic Asian economies investing offshore. Joint ventures with local enterprises are also fairly widespread;
- their modernizing influence on the host country's economy, the possibility of experimenting with policy instruments not commonly used or untested in the rest of the economy, and their **ability to facilitate the transition** from a closed economy to a more open economy;
- **job creation**, particularly in depressed regions
- there is also the expectation that the production technologies and organizational know-how introduced by foreign investors would contribute to the **upgrading of workers' skills**. Finally, there is the conviction that the presence of efficient foreign enterprises would have a demonstration effect on indigenous firms and that positive technological spillovers would be facilitated by the **fostering of linkages** between foreign and local enterprises and industries.

Productive, trading and other related economic activities may be carried out in the free trade zones, namely:

- organizing the manufacture of goods and services on an up-to-date technical and technological level, intended for export;

- loading, unloading and handling of duty free imported good earmarked for export;
- storage and safeguarding of duty free imported good earmarked for export
- commercial activity, agency and mediation;
- banking, crediting and other financial operations, insurance and re-insurance of property.

Such agreements existed between the EU and other main OECD developed countries.

Countries with large supplies of labour that is relatively low-cost regardless of the levels of skills and qualifications, are the best candidates for such industrial relocation. Moreover, exports from EPZ host countries generally benefit from schemes such as the United States' and European Union's Generalized System of Preferences. With preferential schemes therefore, advantageous conditions for gaining access to markets in industrialized countries are guaranteed. Moreover, EPZ has a **positive impact on transformation process** in host country, what may confirm Polish example.

"**Special Economic Zones (SEZ)" in Poland** were established by the Special Economic Zone Act of October 20, 1994. Poland now has seventeen of them. The law confers to a SEZ the right to grant investors special tax benefits over a period of 20 years. The purpose of these zones was to create employment by attracting new investment to economically depressed areas that suffer from high unemployment. In September 1997 the Polish Government established nine new Special Economic Zones. Accordance with the Special Economic Zone Act, passed by Parliament on October 20, 1994, the zones provide tax relief to foreign and domestic investors if certain investment and employment criteria are met. The advantages of the Special Economic Zones were only available if the investment in the zone exceeded the certain value and/or a certain employment level. These criteria were established by the local authorities. As SEZ generated growth of GDP in regions and helped to limit budget expenses on payments of unemployment benefits, their role in the transition period of Poland was significant (WSPÓLNOTY EUROPEJSKIE 2002).

Such a free-trade zones was to be set up under the "Common Strategy of the EU on Russia".

Cooperation Agreements

Include preferential but not unrestricted commercial access to the EU market, and beneficiaries are granted EU technical and financial assistance. One of the example are the successive **Lomé Conventions.**

The Lomé Convention sets out the principles and objectives of the Union (at the time Community) cooperation with African, Caribbean and Pacific (ACP) countries. Its main characteristics are:

- the partnership principle;
- the contractual nature of the relationship together with its long-term perspective (5 years for Lomé I, II, and III, and ten for Lomé IV);
- the non-reciprocal preferences for most exports form ACP countries to EEC;
- equality between partners, respect for sovereignty, mutual interests and interdependence;
- the right of each state to determine its own policies;

- security of relations based on the achievements of the cooperation system;
- the promotion of human rights, democracy and good governance; strengthening of the position of women; the protection of the environment; decentralized cooperation; diversification of ACP economies; the promotion of the private sector; and increasing regional cooperation

The new partnership agreement between the European Union member states and the African, Caribbean and Pacific (ACP) states marks five generations of agreements between ACP-EC sovereign states. It is the world's largest financial and political framework for North-South cooperation. This special partnership is characterised by its non-reciprocal trade benefits for ACP states including unlimited entry to the EU market for 99 per cent of industrial goods and many other products, especially for the Least Developed Countries (LDCs) which number 39 in the ACP grouping. In addition, aid packages for each ACP country and region are regularly updated.

A unique feature of the ACP-EC accord is dialogue and joint administration of its content by the Community and the ACP. The ACP states are free to table requests that are mutually negotiated with the EU.

Association Agreements

It is a rather high form of integration with the EU. These agreements include wide commercial preferences in the trade of goods and services, leading to free trade after a transitory period. They plan a process of approximation of laws aiming at ensuring implementation of the four fundamental freedoms, although only the free circulation of goods is itself an objective of association agreements. Association agreements are sometimes asymmetric to the benefit of the EU partner for a limited period. For instance, at the beginning of the enforcement of association agreements with CEE countries, the EU granted duty-free access to its market in most fields immediately, while CEE countries were allowed to phase out their tariffs via annual reductions over five years. Food products are considered separately because commercial rules of the Common Agricultural Policy apply. Association agreements also include institutional cooperation (political dialogue, cultural cooperation, common decision-making institutions, jurisdictional bodies). European agreements concerning Eastern European candidates to EU accession are the best-known examples of such agreements, and they were followed by the pre-accession process.

There is **European Economic Area Agreement of 1992 between EEC and EFTA** which may be used as an example and which experience may be very helpful in creating CEES between the EU and Russia.

On January 17, 1989, Jaques Delors expressed the idea of a global and structured agreement of the 12 members of the EEC with the 7 members of EFTA (Austria, Finland, Iceland, Liechtenstein, Norway, Sweden and Switzerland). This agreement was signed in Porto on May 2,1992. It creates a European Eternal Market representing 95% of the economy of the 19 parties, 380 million consumers and 40% of world trade.

The aim of this Agreement of Association was to promote a continuous and balanced strengthening of trade and economic relations between the EFTA and the EU with equal conditions of competition, and the respect of the same rules, to set-up a *"homogenous European economic area" (Art 1)* binding EFTA countries to the EU.

There are four dimensions to the EEA of 1992:

- (1) “Four fundamental freedoms”
- **(a)** the free movement of goods
- customs duties on imports and exports, and any charges having equivalent effect, are prohibited between the EU and EFTA. Without prejudice to the arrangements set out in Protocol 5, this shall also apply to customs duties of a fiscal nature;
- quantitative restrictions on imports, exports and all measures having equivalent effect are also prohibited between the Contracting Parties;
- the Contracting Parties shall ensure that any State monopoly of a commercial character be adjusted so that no discrimination regarding the conditions under which goods are procured and marketed will exist between nationals of EC Member States and EFTA States;
- The Contracting Parties shall examine any difficulties that might arise in their trade in agricultural products and shall endeavor to seek appropriate solutions. The Contracting Parties undertake to continue their efforts with a view to achieving progressive liberalization of agricultural trade;
- in order to facilitate trade between them, the Contracting Parties shall simplify border controls and formalities;
- re-export towards a third country against which the exporting Contracting Party maintains, for the product concerned, quantitative export restrictions, export duties or measures or charges having equivalent effect; a serious shortage, or threat thereof, of a product essential to the exporting Contracting Party;
- anti-dumping measures, countervailing duties and measures against illicit commercial practices attributable to third countries shall not be applied in relations between the Contracting Parties, unless otherwise specified in this Agreement.
- **(b)** the free movement of persons
- such freedom of movement shall entail the abolition of any discrimination based on nationality between workers of EC Member States and EFTA States as regards employment, remuneration and other conditions of work and employment;
- in order to make it easier for persons to take up and pursue activities as workers and self-employed persons, the Contracting Parties shall take the necessary measures, concerning the mutual recognition of diplomas, certificates and other evidence of formal qualifications, and the coordination of the provisions laid concerning the taking up and pursuit of activities by workers and self-employed persons;
- the freedom of establishment of nationals of an EC Member State down by law, regulation or administrative action in the Contracting Parties or an EFTA State in the territory of any other of these States.
- **(c)** the free movement of services
- activities of an industrial character; commercial character; craftsmen; activities of the professions.
- **(d)** the free movement of capital
- within the framework of the provisions of this Agreement, there shall be no restrictions between the Contracting Parties on the movement of capital belonging to

persons resident in EU Member States or EFTA States and no discrimination based on the nationality or on the place of residence of the parties or on the place where such capital is invested;

- the EU and EFTA shall exchange views and information concerning the implementation of this Agreement and the impact of the integration on economic activities and on the conduct of economic and monetary policies. Furthermore, they may discuss macro-economic situations, policies and prospects. This exchange of views and information shall take place on a non-binding basis.
- (2) The setting up of a system ensuring that **competition is not distorted** and that the rules thereon are equally respected;
- (3) **Closer cooperation** in other fields, such as research and development, the environment, education and social policy;
- (4) Institutional and jurisdictional structure.

The EEA membership implies not only establishment of “the common market” but also substantial progress towards harmonization of legislation. The EEA membership effectively means adoption by the member states of the EU legislation and standards. At the same time, the EEA does not envisage establishment of supranational bodies (except for the dispute settlement mechanism). Therefore, the European Economic Area, as a concept, is an approach to economic integration much stronger and deeper than free-trade area agreement. It can be considered as the strongest form of economic integration with the EU short of accession, and sometimes as one possible way of accession. The EEA integration is however clearly distant from accession. EU membership requires, as I mentioned before, full acceptance of the *aquis communautaire.* The Accession Partnership are not agreements between the EU and the new member-countries, but a framework of objectives based on the Copenhagen criteria and the *acquis* and which have been developed after consultation with the countries concerned.

Partnership and Cooperation Agreements.

These agreements were set-up by the EU **with most of the countries of Commonwealth of Independent States**. The content of such agreements is "to promote trade and investment and harmonious economic relations between the Parties" and "to create the necessary conditions for the future establishment of a free-trade area between the Community and Russia covering substantially all trade in goods between them, as well as conditions for bringing about freedom of establishment of companies, of cross-border trade in services and of capital movements" (Art.1). Moreover "each Party shall provide for freedom of transit through its territory of goods originating in the customs territory or destined for the customs territory of the other Party" (Art. 12).

Because the PCA was described closer earlier in this paper, just to remember that the philosophy of such an agreement is to create the conditions for a free-trade area, with the further prospect of developing free movement of services and capital. The sides grant each other most-favoured-nation status in trade and the absence of discriminations concerning goods, labour conditions and the establishment of companies. This regime is much less open than that offered by association agreements. However, the PCA with Russia is oriented towards Copenhagen criteria, with special emphasis on political dialogue, including twice-yearly summits.

5.2 The Concept of Establishing CEES

One of the stated goals of the PCA between the EU and Russia was “to create the necessary conditions for the future establishment of a free trade area between the Community and Russia covering substantially all trade in goods between them, as well as conditions for bringing about freedom of establishment of companies, of cross-border trade in services and of capital movements”. In 1998 it was planned to study the question of whether the time was ripe for beginning talks on the FTA.

The goal of “Russia’s integration into a common European economic and social area” was formulated in the Common Strategy of the EU on Russia (June 1999), which refers to “the future establishment of an EU-RF free-trade area” and subsequently of the **Common European Economic Space** (CEES) as a result of gradual approximation of legislation and standards. The 2002 saw an event which may become crucial for the development of post-Communist Russia. The EU put forward the idea to establish of a Common European Economic Space:

“The concept of a Common European Economic Space will help us create a long-term strategy for economic cooperation. It means bringing Russia and the Union closer by **establishing a compatible legislative base and eliminating technical barriers to trade and investment”**(Romano Prodi).

This long term initiative is already conducted by **High-Level Group (HLG)** established in accordance with Article 93 of the PCA at the Brussels Summit on October 3, 2001 and led by Commissioner Patten on the EU side and Deputy P.M. Khristienko for Russia. The task of the High-Level Group which task is to define the core elements which will need to be put in order to create a Common European Economic Space and to elaborate a concept for close economic relationship between Russia and the EU. Moreover, the High-Level Group considers the opportunities offered by greater economic integration and legislative approximation and assesses options for further work. It also identifies means and mechanisms to achieve common objectives and consider the time-scale for implementation. In its work, the High-Level Group does not replace or duplicate the activities of the cooperation bodies created within the PCA because the CEES is broader and deeper in comparison to the WTO and PCA provisions. However, the High-Level Group fully takes into consideration the obligations that result from the current or future participation of the parties in the World Trade Organization. The outcome of discussions in the High-Level Group is brought to the attention of relevant PCA bodies, including summits. If necessary experts of both sides could be invited to take part in the work of the Group.

The HLG also took into consideration the ongoing economic reform process in Russia as well as developments in the EU Internal Market. For making the concept operational, the objectives set out above will need to be transformed into specific goals and actions by way of action plans. The elaboration of the Action Plans and respective negotiations will be provided under guidance and coordination of the High Level Group. The HLG will report progress to the EU-Russia Summit on a regular basis. Where, however, the envisaged content of an action plan calls for a negotiation to be done, both sides will use their internal rules and principles for preparing and conducting such negotiations should be provided, as was mentioned, under negotiating mechanisms between both sides will be the usual ones. In such cases, the relevant action plan would need to be made a bilateral agreement, to be formalised by way of Protocol attached to the PCA or to take the form of a self-standing agreement as the case may require.

The High-Level Group has met five times to develop the concept. At its second meeting in March 2002, the HLG adopted a work plan for 2002/2003, including the task of assessing the potential impact of a CEES. A first Report of the HLG was made to the EU-Russia Summit on 29 May 2002. A number of studies have been commissioned by the Parties to assess the CEES' impact, both on the economy as a whole and across a range of its sectors. The list includes sectors where cooperation boosts trade and investment and where the trade interest of the EU and Russia is strong, such as: standards, technical regulations and conformity assessment, customs, financial services, accounting/auditing, transport, space launching services, public procurement, telecommunications, competition, industry (*inter alia*, ferrous and non-ferrous metals sectors) and agriculture (*inter alia*, the sectors of meat and meat products, grain production). It also reflects the achievements and experience of integration in the EU. In its report to the Summit in November 2002, the HLG noted with satisfaction that preliminary results of these studies are positive. At the Summit in St. Petersburg in May 2003, the EU and Russia reiterated their intention to reinforce co-operation on a number of issues, including the placing of the CEES project into the broader context of four Common Spaces (economic space; space of freedom, security and justice; space of common external security; space of science, research, education and culture) to be created in the long-term.

The **EU-Russia Summit in November 2003** gave the more detailed idea of what the Common European Economic Space (CEES) may be. In **Annex I. to Concept Paper** the definition, rationale and objectives of functioning CEES are described. It says that the CEES means an open and integrated market between the EU and Russia, based on the implementation of common or compatible rules and regulations, including compatible administrative practices, as a basis for synergies and economies of scale associated with a higher degree of competition in bigger markets. It shall ultimately cover substantially all sectors of economy (THE EC DELEGATION IN RUSSIA 2004). The **CEES aims are**:

- promoting trade and investment between the EU and Russia, based on well-functioning market economies;
- creating opportunities for business operators through common, harmonised or compatible rules and regulations, as well as through inter-connected infrastructure networks;
- enhancing the competitiveness of the EU and Russian economies worldwide.

The CEES concept covers both horizontal and sectoral targets. A number of areas for action have already been considered for action and other sectors/issues shall be added as appropriate.

The CEES shall focus on eliminating obstacles and creating opportunities in four main areas of economic activity, i.e. cross-border trade of goods and trade in services, including relevant regulatory standards and requirements; establishment and operation of companies, related aspects of movement of persons, in the relevant fields of economic activity.

The **main instruments** to be applied in these areas are **market opening** (gradual removal of obstacles to trade and investment between the EU and Russia), **regulatory convergence**, and **trade facilitation** (simplification, standardisation and automation of trade procedures). In all of these areas, the Parties shall promote closer and more structured permanent relations between their respective institutions, whether public or private (THE EC DELEGATION IN RUSSIA 2004).

Currently, attitudes toward such an integration are becoming increasingly positive both in EU and in Russia. There is strong believe that the Common European Economic Space is blueprint for economic integration. A high degree of regulatory and legislative convergence, as well as trade and investment facilitation may create substantial benefits for both the EU and Russia, not least in permitting economic agents to operate subject to common rules and conditions and boosting business and investor confidence in the predictability and transparency of rules. However, economic integration between the two partners is not an end in itself: giving it a further boost will enhance general prosperity on both sides, improve the standards of living, increase the protection of human health and well-being as well as of the environment, and ultimately serve the purpose of political stability in the region and world-wide.

The concept of the CEES between the EU and Russia aims at injecting similar integrating dynamics, which, as in the EEA go, far beyond trade liberalization (SAMSON 2002). At the nigh Summit on 29 May 2002 in Moscow was said that at the heart of CEES lays the notion that Russia would use the present economic reform program to make its own laws and regulations compatible with EU's. The EU for the first time has stated in the **European Commission's communication 'Wider Europe'** that the bases for tightening co-operation between the EU and its neighbours include not only democratic and free-market changes in those countries, but also the **gradual acceptance by them of legal solutions binding on the Union itself.**

If the main future of this idea is the implementation of a **Single Market** between Russia and EU and ensuring the four fundamental freedoms - **free movement of goods, persons, services and capital**. That means that this closer association between the EU and Russia will impose on Russia requirements and the adoption of **the Maastricht and Copenhagen criteria**, as well as special reports by the European Commission (evaluating the degree of preparedness of individual some countries) for more detailed targets to be developed for Russia. More generally, it can be said in the light of the EEA experience that harmonization of legislation becomes a necessity sooner or later, even in fields that were excluded from the original agreement, since benefits from the **Single Market** are not fully exploited.

Remaining within the economic framework, adaptation of **European standards** should be undertaken primarily in the following areas:

- existence of a functioning **market economy**;
- ability to secure effective competition and operation of market forces (**deregulation** and establishment of competitive conditions, legislative stability and transparency of fiscal policy);
- implementation of **structural reform** with a focus on protection of property rights, effectiveness of bankruptcy legislation, efficiency of the tax system, stability of the banking sector, and of financial markets;
- **monetary and fiscal** policies to promote steady growth;
- establishment of **administrative and government** institutions in line with European standards.

Building in Russia market institution as the first condition for launching an integration dynamic within the CEES will intensify mutual flows of trade and investments.

Financial standards are specified by the Maastricht agreements (SAMSON 2002):

- price stability: annual inflation within 1.5 percentage points of the three best performing EU countries;
- annual government deficit not to exceed 3% of GDP;

- debt: total outstanding government debt not to exceed 60% of GDP;
- exchange-rate stability, meaning that for at least 2 years the country concerned has kept within the “normal” fluctuation margins of 2.5% envisaged by the European Exchange Rate Mechanism;
- average nominal long term interest rate must be within 2 percentage points of the average rate in the three countries with the lowest inflation rates.

There are still many points that need to be further spelled out and clarified in these proposals. The conclusion that European standards should be used applied, **requires** some **qualification**. All the existing vagueness and lack of detail, as well as technical and legal problems, which in practical implementation of this idea may bound to encounter, depend on the development of key institutional guidelines for the socio-economic transformation of Russia. It is precisely the adaptation to Russian conditions of European institutions that is also the aim of the Strategic Program to 2010. The level of economic development and education, GDP structure, the social structure of population, and for that matter the current political system, make the choice of European standards the most natural and appropriate. Of the special importance today are: the complex of goals relating to macroeconomic conditions, fulfilment of the criteria associated with the establishment of a functioning market economy, transformation, ability to secure effective competition and operation of market forces, successfully completed domestic reforms and adaptation of standards laws and regulations compatible with EU (which may also help Russia to receive status of “market economy”). The broad **adoption of the *acquis communautaire*** in six chapters, is based on directives that have to be transcribed into national laws, and regulations that have to be implemented. Therefore, **administrative reform** building for enforcement and implementation of laws and unification of the internal Russian market is also of interest, because without these changes the CEES will not be able to function properly and the quick shift towards a sustainable growth model will not happen. In Russia this issue is important, not alone at the federal level, but also because of the current practices of regional authorities. Without also a prior **improvement of the business climate**, company law and competition policy, demonopolising the banking sector or creating the conditions of freedom of establishment and service provision, the positive impact of broad liberalization measures in the movement of goods and services cannot produce all its effects. As regards existing cooperation several other issues offer scope for initiating or deepening cooperation they include: transport, fishing, telecoms and IT. **Employment and social policy** is a field, which has priority for Russia and in which the EU has extensive experience. Another special field for new cooperation is the internal and **external use of the euro** by Russia. There is also a broad field of discussion between the two parties for defining the **free movement of persons** between the EU and Russia. This was also stressed by EU commissioner Chris Patten during the Moscow Summit of December 3, 2001. Free movement of persons is the highest confidence that the EU can give Russia and although it seems to be nowadays unrealistic perhaps within the CEES it will be possible. If a strong and efficient impulse is given to the creating of a CEES between the EU and Russia, with strong investment activity and an economic growth in Russia, the prospect of free movement of persons may seem to be realistic.

Russia’s **accession to the WTO** and the OECD (formal application to the OECD was filed as long ago as 1996) are natural stations on the way to the European-type institutions. Russia’s accession to the WTO, which is meant to contribute to the major political and economic objective or integrating Russia into the world trading system, may help to strengthen the bilateral economic co-operation between Russia and the EU, and together with the EU-Russia Partnership and Co-operation Agreement help to remove obstacles to trade and investment, thus paving the way for the creation or a Common European Economic Space. Nevertheless some experts are in the opinion that it may not be right to focus first on WTO accession, but on building CEES. As WTO accession is a huge task, the CEES process may wait for a long time for the outcome of the WTO discussion, another reason is that the lack of an institutional framework based on the impulse provided by the *acquis* might unable Russia to get the full benefit of economic opening and other advantages associated with WTO accession

All above criteria and the macroeconomic convergence would make Russia's economic integration with EU closer. However, these criteria should not be identified with the Russia's goal of EU accession. Moreover, all of them should be applied to actual Russian realities and practices. As it happens, Russia is already ahead of the EU as regards some socio-economic decisions or institutions. This is true of the tax system, fiscal policy (orientation to a zero-deficit budget), and labour legislation. It should also be recognized that Russia's current agricultural policy (meaning essentially, the principles of relations between the government and the agricultural sector) is more efficiency-oriented than that of the EU. There should also be no formal alignment of Russian institutions with European ones if that were to impair Russia's competitive advantages. There should be also standards developed in Russia and for Russia. There can be no question of parameters being developed jointly with the EU or under control of European entities. The idea is that Russia should determine its own targets and goals rather than formalize its desire to join the EU. For the first time since the collapse of Communism, Russian society may come to recognize and formulate its own long-term development path. If this is truly the case, then Russia will at one and the same time define criteria for appraising politico-economic decisions and results of their implementation. The discussion of options for the CEES should also take into account the greater economic distance between the EU and Russia compared with that between that EU and CEE countries. This is first reflected by levels of economic development, but also by economic history and the late and young capitalism that appeared in Russia at the end of the 19th century. Russia is neither an EFTA nor a CEE country. Its national specifies, both geographical and historical, must be taken into consideration, as well as the specific features of its society. Moreover the CEES concept should take into account Russia's specific situation, and the **asymmetry** caused by its low per capita GDP and institutional development. **Russia's per capita GDP** is lower than average CEE countries, and of course much lower than EFTA countries when the EEA was created in 1992. This fact should be taken into account when discussing the the CEES and the transition phases, which Russia would need in adopting the *acquis.* The CEES may be the best tool for quickly reducing the asymmetry**.**

In the end of my paper I would like to present as a counterbalance to what was said above also a totally different view of establishing Common European Economic Space. **Shemiatenkov**, the Principal Research Fellow at the Institute of Europe in Moscow and former Ambassador of the Soviet Union to the EU, noted that **contrary to neo-liberalist economic theory**, Russia would not benefit from open borders with the rest of the world. Instead of exporting their products, Russian manufacturers will want to use their advantages in their home market and the Commonwealth of Independent States (CIS). As prospects for the free trade area become uncertain, so too do the chances of Russia's approximation with the European Union. In the meantime, it has become clear that Russia will not become a part of Europe. "The dream we had twelve years ago has been torpedoed," Mr Shemiatenkov said, adding that there were no economic reasons for establishing a free trade area. "Now this bridge has been closed." While some of Russia's western provinces would clearly benefit from closer economic ties with western Europe, Mr Shemiatenkov underlined that the eastern provinces have much more to gain from trade with Asia. A free trade arrangement with

Western Europe will further aggravate trade relations within the Commonwealth of Independent States. And, last but not least, unrestricted trade policy freedom may give the re-emerging Russian economy a better chance to tap the new opportunities created by globalisation. In the latter case it would be only reasonable to re-visit the Partnership and Co-operation Agreement and consider the feasibility of other possible forms of co-existence with Western Europe. For instance, if there is no prospect of joining the Union in the foreseeable future, the idea of creating a free trade area becomes rather unattractive. It will certainly give unilateral advantages to EU manufacturers and may seriously hinder the renaissance of the crisis-striken Russian industry. It may exacerbate the conflict of interests between European particularly north-western Russian regions, on the one hand, and the Russian Far East and Eastern Siberia which seem to be gravitating to the Pacific Rim (SHEMIATENKOV 2000).

Many options remain open for the CEES concept and its main features and elements, which are less precise and same times less binding. However, most opinions are in favour to establishing CEES. Through the building of a CEES and anchoring of Russia's economic growth and institutional change to the European Union, the world's biggest economy, will allow rapid changeover to a strong and sustainable growth model in Russia. If developments follow a favourable scenario, Russia's position in Europe could, in a strategic perspective, be similar to the current partnership between the EU and Norway (looking here to the precedent rather than to specific forms). The creation of Common European Space between Russia and European Union, is the most important concept nowadays between EU and RF which may allow Russia to enhance its economy and take full advantages of EU Eastern Enlargement. Therefore, the basis for the discussion and for the success of the implementation process should be of mutual interest.

Appendix 1 : The Impact of Market Integration - A Comparative Statistic Analysis using a Simplified Model (GOTO, 1995)

Three simplifying assumptions:

- *Three countries.* Country 1 and Country 2 are the prospective member countries (e.g. France and Germany), and the country 3 is the outside country (e.g.Russia)
- *The same economic size.* The factor endowments of the three countries (L_i) are assumed to be the same.
- *The symmetric tariff.* The levels of the external tariffs of the three countries are assumed to be the same.

I. Equilibrium before Integration

Adding the above three simplifying assumptions, let us examine the possible impact of the EU integration on Russia. By assumption 2, the following equality holds:

(1) $L1 = L2 = L§(= L)$,

By assumption 3, equation (2) holds in the equilibrium before country 1 and country 2 are integrated, where t_{iM}, t_{jM}, and t_{kM} are tariff rate in country M imposed on good produced in country 1,2, and 3, respectively:

(2) $ti2 = ti3 = tjl = tj§ = tkl = tk2(= t)$,

Note that after the integration, t_{i2} and t_{j1} become zero.

Further, it should be noted that, when the above three assumptions are adopted, the analysis becomes much less complicated due to the symmetry of the problem. The following relations are especially useful for the analysis. In what follows, P_{iM}, P_{jM}, *and* P_{kM} are the prices quoted in country M of the goods produced in country 1, 2, and 3, respectively, and C_{iM}, C_{jM}, and C_{kM} are the amounts of consumption in country M of the differentiated products produced in country 1, 2, and 3, respectively.

(3) $Pi1 = Pj2 = Pk3 \ (= Ph;$ price of home goods),

(4) $W1 = W2 = W3 \ (= W;\ W$ will be set to unity),

(5) $l = l1 = l2 = l3,\ (= l;$ labor input of each firm),

(6) $n = n1 = n2 = n3 \ (= n;$ the number of firms of each country),

(7) $Pi2 = Pi3 = Pjl = Pj3 = Pkl = Pk2 \ (= Pf;$ price of foreign goods),

(8) $Cil = Cj2 = Ck3 \ (= Ch;$ consumption of home goods),

(9) $Ci2 = Ci3 = Cjl = Cj3 = Ckl = Ck2 \ (= Cf;$ consumption of foreign goods)

(10) $Y1 = Y2 = Y3 \ (= Y;$ national income),

With the above symmetry relations, the equilibrium conditions before integration reduce to the following:

(11) $Ph = m / \beta$

(12) $Pf = m(1 + t) / \beta$,

(13) $PhCh + 2PfCf/(1+t) - F - m(Ch + 2Cf) = 0$

(14) $l = F + m(Ch + 2Cf)$,

(15) $nl = L$

(16) $L + 2tPhCfn = Y$,

(17) $Ph = C^{\beta-1}{}_{h}Y/Z$,

(18) $Pf = C^{\beta-1}{}_{f}Y/Z$,

(19) $Z = n(C^{\beta}{}_{h} + 2C^{\beta}{}_{f})$,

In order to obtain the equilibrium values of endogenous variables, the system of the above equations should be solved. The following simplifying expressions for the equilibrium values of all endogenous variables is obtained:

(20) $P_h = m/\beta$,

(21) $P_f = m(1+t)/\beta$,

(22) $l = F/(1-\beta)$,

(23) $n = (1-\beta)L/F$,

(24) $C_h = \{\beta F/[m(1-\beta)]\}\{1/[1 + 2(1+t)^{-1(1-\beta)}]\}$,

(25) $C_f = \{\beta F/[m(1-\beta]\}\{1/[2 + (1+t)^{1/(1-\beta)}]\}$,

(26) $Y = \{1 + [2t/[2 + (1+t)^{1/(1-\beta)}]]\}L$,

(27) $Z = n\{\beta F/[m(1-\beta)]\}^{\beta}\{\{1/[1 + 2(1+t)^{-1/(1-\beta)} + 2]\}^{\beta}\}$,

It should be noted that several interesting relationships in the above equilibrium conditions can be observed. From equations (24) and (25), the following derivative conditions hold:

(28) $\partial Ch/\partial t > 0$,

(29) $\partial Cf/\partial t < 0$,

Namely, when tariff rate increases, the consumption of borne goods increases while that of foreign goods decreases. Further, comparing equation (24) with equation (25), we have

(30) $Ch > Cf$ when $t > 0$,

(31) $Ch = Cf$ when $t = 0$

II. Equilibrium after Integration

Now let examine what will happen if country 1 and country 2 are integrated. Here, integration means the lifting of tariffs between the two countries. Therefore, in order to obtain the equilibrium after integration, all we have to do is to plug equation (32) into the above specification before integration.

(32) $t_{i2} = t_{jl} = 0$,

It should be noted that in the equilibrium after integration, the neat symmetry conditions among the three countries no longer hold. However, the following relations still hold in equilibrium after integration.

(33) $W1 = W2$ $(= W;$ =W; but still $W3 = 1$ $W3 = 1$,

(34) $Pil = Pj2 = Pi2 = Pjl(= PA)$,

(35) $Pi3 = Pj3(= PB)$,

(36) $Pkl = Pk2(= Pc)$,

(37) $Cil = Cj2 = Ci2 = Cjl(= CA,)$

(38) $Ci3 = Cj3(= CB)$,

(39) $Ckl = Ck2(= Cc)$,

(40) $lI = l2(= l)$,

(41) $n_1 = n_2(= n)$,

(42) $Y1 = Y2(= Y)$,

Using the above relations, the equilibrium conditions after integration of country 1 and country 2 can be expressed as follows:

(43) $PA = mW / \beta$,

(44) $PB = m(1+t)W / \beta$,

(45) $Pc = m(1+t) / \beta$,

(46) $Pk3 = m / \beta$,

(47) $2PACA + PBCB / (1+t) - WF - Wm(2CA + CB) = 0$,

(48) $2PcCc / (1+t) + Pk3Ck3 - F - m(2Cc + Ck3) = 0$,

(49) $l = F + m(2CA + CB)$,

(50) $13 = F + m(2Cc + Ck3)$,

(51) $nl = L$,

(52) $n3l = L$,

(53) $WL + tPcn3Cc / (1+t) = Y$,

(54) $L + 2tP_B nC_B / (1+t) = Y3$,

(55) $P_A = C^{\beta-1}{}_A Y / Z$,

(56) $P_C = C^{\beta-1}{}_C Y / Z$,

(57) $P_B = C^{\beta-1}{}_B Y / Z$,

(58) $P_{k3} = B^{\beta-1}{}_{k3} Y_3 / Z$,

(59) $Z = 2nC^{\beta}{}_A + n_3 C^{\beta}{}_C$,

(60) $Z_3 = 2nC^{\beta}{}_B + n_3 C^{\beta}{}_{k3}$,

By Walrus's law. one of the above 18 equations is redundant, so 17 independent equations determine the equilibrium values or 17 endogenous variables *(P_A, P_B, P_C, P_{k3}, C_A, C_{k3}, C_C, C_{k3}, W, l, l_3, n, n_3, Y, Y_3, Z, Z_3)*. Note that, due to the symmetry of the problem, P_{k3} (and C_{k3}) are the same for all k.

1. Impact on Production

First of all, let examine how the production side is affected by the integration. Substituting equations (43) and (44) into equation (47), and rearranging the terms, we obtain

(61) $2C_A + C_B = \beta F / m(1-\beta),$

Note that the left-hand side of equation (61) is equal to the amount or production by each firm in country 1 (and country 2) after integration. Similarly, substituting equations (43) and (44) into equation (48) and rearranging, we have

(62) $2C_C + C_{k3} = \beta F / m(1-\beta),$

Again note that the left-hand side of equation (62) is equal to the amount of production by each firm in country 3 after integration.

Substituting equation (61) into equation (49), we obtain

(63) $l = F/(1-\beta,)$

Similarly, substituting equation (62) into equation (50), we get the following:

(64) $l_3 = F/(1-\beta,)$

Comparing equations (63) and (64) with equation (22), we know that the amount of labor input (and therefore the amount of production) of each firm after integration is exactly the same as that before integration. In other words, the production in each firm is not affected by the integration of country 1 and country 2. Furthermore, by substituting equations (63) and (64), respectively, into equations (51) and (52), we obtain the following:

(65) $n = (1-\beta)L/F,$

(66) $n_3 = (1-\beta)L/F,$

Comparing equations (65) and (66) with equations (23), we know that the number of firms in each country is not affected by the integration. That means the production side is not affected at all by the integration, and therefore, the problem reduces to the allocation of goods to each country.

2. Impact on Wage Rate.

Having shown that we find that the production configuration remains the same as that before integration, let us now examine the impact of the integration on other variables. Consider the impact on wage rate first. From equations (55)-(58), (62), and (63), we can derive equation (67) after tedious manipulation:

(67) $(1+t)^{1/(1-\beta)} W^{1/(1-\beta)} + 2W = 1 + 2(1+t)^{1/(1-\beta)} W^{\beta/(\beta-1)},$

Although equation (67) looks complicated, note the following two points:

- the left-hand side of the equation is a monotonically increasing function of *W,* while the right-hand side is a monotonically decreasing function of *W;* and
- when *W* is equal to one, the left-hand side is smaller than the right-hand side.

Therefore, from these two points, we know the following relationship:

(68) $W > 1$,

Equation (68) shows that after integration, the wage rate in country 1 and country 2 is greater than that in country 3.

3. Impact on Terms or Trade.

Now, let examine the impact or integration on the terms of trade. The terms or trade of country 3 (i.e., or the outsider) is expressed as follows:

(69) The terms of trade of country $3 = P_C / P_B$,

Dividing equation (45) by equation (44), we obtain

(70) $P_C / P_B = 1/W$,

From equations (68) and (70), we have

(71) $P_C / P_B < 1$,

Since the terms of trade before integration equal 1, as is clear by the specification of the equilibrium before integration in the last section, equation (71) implies that the terms of trade of country 3 (outsider) worsens after the integration of country 1 and country 2. As is well known, a worsening of the terms of trade of outsiders has been pointed out by the traditional customs union theory based on imperfect competition and constant returns to scale. Here, equation (71) shows that the same result holds even under new framework.

4. Impact on Consumption and Welfare.

What would happen to the amount of consumption in each country after integration? From equations (55)-(58), we obtain

(72) $C_C = WC_{B,}$

From equations (68) and (72), we obtain

(73) $C_C > C_B$,

Further, we already know that the amount or production in each firm does not change after integration. Therefore:

(74) $2C_A + C_B = 2C_B + C_{k3} = C_h + 2C_f$,

From equations (73) and (74), we obtain

(75) $2C_A + C_C > 2C_A C_B = C_h + 2C_f$,

Equation (75) shows that the amount of consumption of each member country increases after integration. The increase in consumption suggests that the utility levels also increase in member countries. By some tedious manipulation, we can rigorously prove that this is in fact the case.

Similarly, the impact on the consumption country 3 (outsider) can be determined. From inequality (73) and nothing that the amount of production remains unchanged after integration, we obtain the following relations:

(76) $2C_B + C_{k3} < 2C_C + C_{k3} = 2C_f + C_h$,

As shown in equation (76), the amount of consumption (and the level of the utility) in the outsider country decreases after integration of the remaining two countries.

5. Impact on Trade Pattern – Trade Creation and Trade Diversion

Next, let's examine the impact of economic integration on the pattern of trade. From equations (55)-(58), we can derive

(77) $C_{k3} = W^{(1+\beta)/(1-\beta)} C_A$,

From equations (57), (58), (70), and (77), we obtain

(78) $(1+t)^{1/(1-\beta)} W^{1/(1-\beta)} = C_{k3} / C_B$,

Further from equations (24) and (25), we obtain the following equation:

(79) $C_h / C_f = (1+t)^{1/(1-\beta)}$,

From equation (68) we already know that *W* is greater than one, and therefore, from equations (78) and (79), we have

(80) $C_f / C_h > C_B / C_{k3,}$

Note that equation (80) implies

if $C_{k3} < C_h$ then $C_f > C_B$

Further, note that equation (76) implies

if $C_{k3} \geq C_h$ then $C_f > C_B$.

From (i) and (ii), inequality (81) holds in all cases:

(81) $C_B < C_f$,

Note that C_B is equal to the amount of exports from country 1 (or country 2) to country 3 after the integration. Therefore, equation (81) shows that the amount of exports from members to the outsider is reduced by the integration. Furthermore, after tedious manipulation, we can show the following:

(82) $C_C < C_f$,

Also note that C_C that is equal to the exports from country 3 to country 1 (or country 2) after the integration. Thus inequality (82) shows that the amount of exports from the outsider to each member country will be reduced by the integration. From inequalities (81) and (82), can be concluded that the amount of trade between the members and the outsider will decline after the integration (***trade diversion***)

What would happen to the amount of trade between the member countries? As discussed above, since the amount of production by each firm does not change after integration, we have

(83) $2C_A + C_B = 2C_f + C_h$,

Substituting equation (82) into inequality (79), we obtain

(84) $C_A > (C_f + C_h)/2$,

From equation (30), we already know $C_h > C_f$; therefore,

(85) $C_A > C_f$.

Note that C_A is equal to the amount of exports from country 1 (country 2) to country 2 (country 1) after the integration. Therefore, inequality (85) shows that the amount of trade between member countries increases after the integration (***trade creation***)

Concluding Remarks

Established above a simple general equilibrium framework for the analysis of integration (e.g.within EU), is based on some new assumptions such as imperfect competition, increasing returns to scale, and product differentiation. Using the general equilibrium model, impact of integration mainly on the outside country have analysed. The main findings of this chapter and their implications are summarized and discussed below.

1. Terms of Trade Effect

After the integration, the terms of trade of the outsider worsens, unless there is an additional liberalization of the EU's imports from the outside country.

2. Trade Pattern Effect

After the integration, the amount of trade between member countries increases (trade creation), but trade between the members and the outsider declines (trade diversion). This implies that after the completion of the EU single market, the trade between EU countries and the third country tends to decline, again unless trade liberalizing measures are taken by both the third and the EU countries.

3. Consumption and Welfare Effect

After the integration, the amount of consumption (as well as the utility level) of the outsider would decline, while those of the member countries would increase. This suggests that the third country would be adversely affected by the completion of the EU single market.

Appendix 2 : Tariff and Non –Tariff Barriers in Russia's Trade Policy

I. RUSSIA'S TARIFFS AND DUTIES

Import Tariffs

Import Tariffs are Russia's main trade policy instrument regulated by the Russian Federal Law "On the Customs Tariff". In November 2000, the government adopted a new four-tier system of customs duties that came into force on 1 January 2001. The tariff cuts sliced maximum rates from 30 to 20 %, but tariffs average at about 10 % (11% before the tariff reduction). The new four-tier run scale includes levels of 5, 10, 15 and 20 %. The major exception to the new system is automobile imports, which are subject to a special 25 % tariff, to protect the domestic car industry. However, this rate is lower than the previous 30 %. Other exceptions are poultry, sugar, spirit and tobacco. As Russia is not yet a Member of the WTO, it has not bound its tariff rates. Russia is currently negotiating the terms of its WTO accession. Russia's new import duty scale forms the cornerstone of the government's reform of the customs system, which aims to remove obstacles to Russia's WTO accession.

Excise and VAT

Russia has already taken steps to equalise the treatment of imported and domestically produced goods for the purposes of internal taxation. These are being assessed by the EU.

Other tariffs and duties

- **Consular fees**

Russia levies consular fees connected with imports or exports of goods or services which do not apply to all foreign companies on a non-discriminatory basis and do not appear to reflect always the actual cost of services rendered. Current differences in the level of charges applied by Russian consular offices in third countries do not appear justified. In many cases, including in relation to the certification and authentication of documents, the consular fees levied in the CIS and Baltic countries are ten times lower than those levied elsewhere.

- **Wine tariffs**

The specific duties on alcoholic beverages (wines, Vermouths and other fermented beverages) have been replaced by 25 % ad valorem tariffs as from 1 April 2000, following decision No. 1365 of December 1999, of the Government of the Russian Federation, of 9.12.1999. They have since been reduced to 20% ad valorem tariffs, as from 1 January 2001. The Russian side explained that this governmental decision was a response to the EU, World Bank and the International Monetary Fund requirements to replace a number of tariff lines, for which duties were applied, with ad valorem duties. However the EU wine industry still complaints that, when compared to 1999 duty levels, this change in tariffs results in a global increase in duty for EU wines, in particular for higher value wines. The average ad valorem equivalent for EU exports, which would correspond to previous specific duties, is close to 10%. Generally speaking, specific duties are more favourable to trade in quality wines, whereas ad valorem duties favour import of cheap wines. Besides, the introduction of ad valorem duties increases the incentive for fraud and under-declaration of the custom value.

Thus these elements are particularly unfavourable for the EU wine exports, when compared to other competitors (CIS, New World).

II. TRADE DEFENCE INSTRUMENTS

The Russian Federal Law "On the Customs Tariff" provides the framework for the application of anti-dumping and countervailing duties and "special" duties to be applied as safeguard measures. Russia is preparing a range of new legislation in the area of trade defence instruments that should supersede existing legislation, as well as implementing regulations on procedures of investigation and for the determination of injury. These legislative proposals include a draft Federal Law on “Additions and Amendments to the Federal Law on Protection of Economic Interests of the Russian Federation in Foreign Trade in Goods”, a draft Federal Law on Safeguard, Anti-Dumping and Countervailing Measures applying to Imports of Products” and a draft Federal Law “on State Aid”. The PCA recognises that Russia is in transition to a full market economy. A special regime, therefore, exists in the field of trade defence instruments, whereby "normal value" of a product can be established outside Russia. However, a Russian firm in the course of an anti-dumping investigation may request individual market economy treatment if it can demonstrate that its exporting activities are determined by market forces. Both sides are allowed to take safeguard measures in cases where a product is imported under such conditions and quantities that it will cause or threaten to cause substantial injury to domestic producers. In the framework of the WTO, Russia should ensure that all legislation concerning this area in place at the time of her accession or implemented in the future is in full conformity with the relevant provisions of the relevant WTO Agreement. The Commission is, therefore, concerned that investigations undertaken by Russia and measures subsequently applied for the purposes of trade defence are not fully consistent with provisions under the PCA and WTO requirements. For example, under current legislation, anti-dumping investigations seem to be limited to injury and causality aspects, without requiring any proper determination of dumping, and subsequent measures are expected to remain in place for "a limited period of time necessary to eliminate the injury", which does not necessarily comply with the 5-year maximum duration of measures established in the WTO Anti-Dumping Agreement. The EU has requested Russia to make firm commitments in the area of trade defence instruments during her WTO accession negotiations. As to **safeguards**, the Commission is particularly concerned about the recent increase in safeguard actions taken by Russia against EU exports. Russia has indeed initiated six new investigations between 2000 and 2001 and has thereby become one of the leading users of this instrument worldwide. The Commission considers that contrary to anti-dumping, safeguard measures concern fair trade and should therefore be an exception to trade liberalisation. It seems also that Russia has not always respected PCA provisions which provide for bilateral consultations prior to the introduction of definitive measures. While of course not contesting the right of Russia to use this instrument, the Commission expects that Russia takes the utmost care to respect bilateral obligations and given the fact that Russia is seeking to join the WTO, she would start WTO standards when taking action in the trade defence area. Four measures are currently in force (called “special measures” under Russian domestic legislation - one was just concluded with the imposition of definitive measures (potato and maize starch). Two investigations are currently ongoing (caramels and refrigerator parts). Given the size of the Russian market, most of these actions tend to have a significant impact on EU trade.

Caramels (safeguards)

The investigation was initiated in February 2001 in respect of all third countries exporting to Russia. The product concerned is sugar confectionery (caramels, toffees and boiled sweets). A 6 month provisional safeguard measure was imposed in May 2001. With respect to the substance of the case, it should be pointed out that even though exports to Russia indeed increased from 1998-2000, the level of exports in 2000 is roughly the same as in 1997 in tonnage and lower in value. Definitive measures were announced in October with an offer to hold consultations. It should be noted that according to the definitive result of the investigation the EU share of total imports went down from 18.2% in 1998 to 6% in 2000, while imports from Ukraine increased from 68% to 92%. In addition, there was no reference to price undercutting by the EU which confirms the Commission's view that Ukraine is solely responsible for the low priced imports causing injury. Consultations with Russia on the provisional measures were held in September 2001 with no appreciable result. According to Article 17 PCA the EU has the right to a second round of consultations before Russia can introduce definitive measures.

Refrigerator parts (compressors) (safeguards)

The investigation was initiated in April 2001 in respect to all third countries exporting to Russia. On substance, it appears that the EC is the main exporter. However, according to Eurostat, EU exports were actually stable from 1998-2000 and even went down from 1999-2000. Here again, the EU has the right to a second round of consultations before Russia can introduce (definitive) measures.

III. NON-TARIFF BARRIERS

Restrictive customs clearance on certain border crossings

Russia has also imposed restrictions that require customs clearance for certain goods, including textiles and clothing and electrical products, to take place only on border crossings with certain named Asian countries as well as in ports and airports. Consequently such items originating in Asia can no longer be exported to Russia via the EU. These decrees make it impossible for EU companies exporting to Russia to use raw materials from the Far East for sub-contracting and subsequently creates a barrier to EU-Russian business co-operation.

The cumulative effect is that EU exporters to Russia face unpredictable, non-transparent, lengthy and generally burdensome customs procedures for imported goods at the point of entry into Russian customs territory. The EU accepts that appropriate checks on imported goods may be called for to ensure that Russian regulatory requirements are respected, but such measures should not be applied in a heavy-handed or non-transparent way.

*Inconsistencies/non-transparency of administrative decisio*ns

The EU industry and exporters have regular complained of inconsistencies between administrative decisions taken by Russian authorities and the prevailing Russian legislation. Moreover, inconsistencies exist between the general legislative framework and subsidiary regulations and administrative guidance issued by Russian government bodies (such as the State Customs Committee). Furthermore, administrative orders issued by the State Customs

Committee are sometimes issued as “secret orders” and their contents are not publicised to traders. Under State Customs Committee Order No. 949 of 1 October 2001, certain goods qualified as high-risk (e.g. certain foodstuffs) are not released for free circulation without the specific approval of a "higher customs authority". The process of obtaining such approvals can last up to 1-2 weeks. Under rules introduced in October 2001 by the North Western Customs Authority, shipments of “risk products” (a wide group of products including coffee, furniture, tyres and washing machines) are subject to burdensome documentary requirements, including in relation to the ownership of the vehicle transporting the goods.

Standards and Certification

Most industrial sectors are affected by problems in the field of standards and certification as these problems are of a horizontal nature. The problems originate in the systems left over from the Soviet Union, and relate mostly to the erratic and contradictory Russian legal process, insufficient alignment with international standards, and an excessive use of pre-market third party certification, resulting in high costs and considerable delays for European exporters. In addition, standards are often compulsory and very detailed, unlike in the EU, and mandatory third party certification applies for whole ranges of products for which self-certification by the manufacturer is accepted in the EU. The application of standards and certification requirements lacks transparency, and is often arbitrary. Changes to the certification requirements are made frequently and not always sufficiently publicised. This combination of excessive testing, over-prescriptive requirements, high fees, considerable delays, untransparent application, and frequent changes constitutes one of the most serious barriers to market access for EU exporters to Russia. However, as foreseen in the Partnership and Cooperation Agreement (PCA), Russia has undertaken to reduce the differences between the EU’s system of standardisation and conformity assessment and its own by “encouraging the use of internationally agreed instruments in this field” (art. 60 PCA) and has also committed itself to “ensure that its legislation will be gradually made compatible with that of the Community”, notably in the field of “technical rules and standards” (art. 55 PCA). In addition, Russia’s bid to join the WTO implies in particular compliance with the agreement on Technical Barriers to Trade (TBT). In this respect, Russia has drawn up at the end of 1997 a TBT Action Plan and has accepted the following year a list of indicative commitments in the field of TBTs drawn up by the Commission. In spite of these commitments, progress is insufficient. Discussions between the Commission and the Russian authorities have been going on for several years on these matters, both in the PCA framework and in the context of WTO accession, and they have been backed up by significant technical assistance under the TACIS programme. Assistance in the area of harmonisation of standards has also been provided by the World Bank. Progress so far has been uneven. Whereas harmonisation of Russian standards with European and international standards is proceeding at a reasonable pace (35% in 2001, project of 45% in the years to come), there has been less progress on systemic issues.

Progress to-date and main remaining problems

With regard to standards, harmonisation with European and international standards has been progressing at a steady pace. However, a worrying element is the fact that Russia continues to ignore the distinction between compulsory technical regulations and voluntary, non compulsory standards. Instead, about 2000 State standards comprise some compulsory elements, while the rest is voluntary. This solution lacks transparency. Besides, in addition to ‘State standards’ (and inter-State standards produced in the framework of the Euro-Asian

Inter-state Council for Standardisation, Metrology and Certification), there is a variety of other 'standards', such as branch standards, which are a heritage of the former Soviet system and whose legal status is unclear.

With regard to conformity assessment, the main problem remains excessive reliance on mandatory third party certification, including for lower risk products which, in the EU, are subject to less stringent requirements, or are even not subject to any form of compulsory conformity assessment (registration or certification of 82% of products in Russia, 4% in EU – data from the EU industry). This is contrary to the TBT agreement's principles of least trade-restrictiveness and proportionality and to international practice, as well as unnecessarily rigid and costly for manufacturers. Russia has not engaged in a process of progressive reduction of the list of goods subject to compulsory third party certification although Gosstandart declared the intention to reduce the list of products subject to compulsory certification. The only positive but minor step in the right direction so far has been Decree 766 of 7 July 1999, which covers a limited number of products in particular in the textiles sector. It provides for a system of 'conformance declaration', which differs from manufacturer's declaration as practised in the EU in that the declaration has to be registered with a conformity assessment body, which might leave some room for bureaucratic problems. It now seems that the new procedure is operational, but to what extent it actually constitutes a simplification would need to be confirmed by European business. Some industry representatives have already complained that the decree has very little impact. For those categories of goods for which the need for Third Party certification can be demonstrated, there should be a choice between product type approval and quality assurance.

In order to ensure that consumers' interests and rights are properly safeguarded an efficient market surveillance system coupled with appropriate product liability legislation should be introduced, especially since many low quality goods sold on open air markets are 'grey area' products, which are not certified. The EU system could be used as a model. However, market surveillance arrangements are presently underdeveloped (ostensibly for financial reasons) and also uncoordinated, with responsibilities shared between several ministries and agencies. A related problem is that Russia does not have horizontal product liability/safety legislation along the lines of the 1985 and 1992 EU Directives. There are sectoral pieces of legislation, sometimes with extremely business-unfriendly provisions (e.g. the 1999 law on food hygiene and safety).

The EU is also worried that Gosstandart continues to concentrate responsibilities in a variety of areas: standardisation, accreditation, conformity assessment, market surveillance (to the limited extent to which it is practised), supervisory and appeal functions, in addition to some regulatory and legislative responsibilities. This is in the Commission's view inefficient and in contradiction with the EU system and with international practice. In addition, it lacks openness and transparency (e.g. consultation with industry and other stakeholders) and could also lead to conflicts of interest. At the moment, there does not seem to be any plans to change this situation.

Another problem is that certification as operated under the responsibility of Gosstandart is often duplicated by testing requirements operated by various Ministries and agencies under various pretexts (public health, environment protection) but often in fact for funding purposes. The coordination between these bodies, which sometimes even have conflicting requirements (in contradiction with the TBT), is said to be non-existent. This is a very business-unfriendly situation that needs to be addressed as a matter of urgency by the Russian authorities, which should aim to set up a sort of "one-stop shop" system wherever feasible.

With regard to the technical aspects of the implementation of the TBT Agreement, there are draft legislative texts on technical barriers to trade that cover these aspects.

On accreditation, a draft text has been prepared but it does not provide for the establishment of a separate accreditation body: Gosstandart would be the responsible organisation. Indeed, a court decision has removed the possibility of accreditation for commercial non-governmental bodies.

Another important aspect is the implementation of new rules. Significant efforts will be needed to achieve consistent and impartial implementation at the operational level. There are reports from the EU exporters that officials, notably at customs, often refuse to apply reformed rules, possibly because they are not aware of them.

The last period of vigorous legislative activities in Russia led to a number of new requirements. However, industry complains that usually it was not given sufficient time to implement new legislation, which often requires serious changes in technological processes. (Example: New state standard GOST R 8.579-2001 introduced a new requirement regarding minimal level of filling for pre-packed goods (70%). The industry was not aware about this coming legislation and was not consulted on the new standard during its development. Time for implementation of the new requirement, which require changes in technologies and packaging, was less than 6 months.)

IV. RESTRICTIVE EXPORT MEASURES

The Commission is extremely concerned about the proliferation of export restrictions imposed by Russia on a large number of products which gravely distort the EU trade and competition. Export restrictions from Russia are recurrent, are linked to frequently changing legislation and may vary in nature, ranging from export prohibitions, discriminating export licences to export duties. The latter vary in relation to the world market price and revenue objectives set by the government. Because these duties are applied on raw materials, their level is often prohibitive and can stop trade completely.

Export Taxes

- **Discriminating export duties**

Russia has maintained export duties on a wide number of products. Under Order N° 710 of 23 July 2001 of the State Customs Committee of the Russian Federation, Russia has again increased such duties and extended their scope, covering 154 headings of the Harmonised System, at rates up to 50% (on products where the duty is expressed in ad valorem terms) and 500€ per tonne (on products where the duty is levied on a specific basis). The level of these export duties is extremely high for certain products, i.e. ferrous scrap: an ad valorem 15% duty (but not less than 15€ per tonne); non ferrous metal scrap: an ad valorem 30% to 50% duty (but not less than 105€ to 1200€ per tonne); energy products: ranging from 30.5€ to 40 € per tonne; hides and skins: ranging from 60€ to 500 € per tonne; wood products: an ad valorem 5% to 10% duty (but not less than duty ranging from 2.5€ to 24€ per m^3).The effect of these duties is to subsidise the domestic downstream processing industry and to discriminate against foreign buyers. For many of the products affected, the effect of the duties is to discriminate against foreign buyers and to raise the level of the export price so that third-country producers (i) encounter their own difficulties of supply for the products concerned,

(ii) suffer from increased production costs resulting e.g. from higher input or energy costs and/or (iii) face a situation where they lose relative competitiveness on the global market for downstream products as a result of the indirect price support given to domestic Russian producers competing in the same markets. This is particularly the case as a result of export duties on minerals, petrochemicals, natural gas, raw hides and skins, metals including non-ferrous metals and scrap, wood products and log, etc. Consultations on this issue are engaged between the European Commission and Russia both in the framework of the relevant fora under the PCA and of the ongoing negotiations on Russia´s WTO accession.

- **Discriminating export licensing**
- **Export subsidies**

Dual prices in the energy sector

In addition to very high export taxes on oil and gas products (varying in relation to the world market price and revenue objectives set by the Government), Russia practices dual prices in the energy sector which make energy artificially cheap for the domestic processing industry, and discriminate heavily against foreign buyers. These practices are highly discriminating and are not applied by other trading partners. The Commission and the European industry consider that the effect of dual pricing in energy is to contribute to an indirect subsidisation of Russian industrial producers and services suppliers, as they do not have to pay a full market price for their energy inputs. This is particularly the case in energy intensive sectors (i.e. fertiliser, non-ferrous metals, steel, and others), where energy can account for a significant share of the price of the final product. This leads to a potential situation of dumping of downstream products once they are exported. The whole situation has implications for the ability of imported goods to compete on the Russian market and can lead to a displacement of EU products from third country markets. Exported goods from Russia also benefit from subsidised transport charges, particularly for transportation by rail. The EU understands however that Russia has recently taken steps to ensure that import/export cargoes are transported to/from Russian ports through the territory of Russia according to the domestic tariffs and that it intends to extend the same principle to all import/export cargoes to/from all frontier points in the near future.

- **Export taxes** – e.g. export duties on ferrous and non ferrous scrap

V. INVESTMENT RELATED BARRIERS

Although Russia has made great strides over the past two years, in building up the political will to develop and then implement sweeping market reforms, much remains to be done, with some reforms still on the drawing board and others on the statute book but not yet in place on the ground. The general feeling among EU investors is that the activities of private business are still severely over-regulated. There is still a lack of predictability in the operating environment for foreign companies, with overlapping or contradictory legislation and/or administrative competencies, which constitutes a major barrier to investment. Other difficulties routenely experienced by EU companies in gaining recourse to the Russian legal system for redress and/or enforcement of legal judgements also still act as a brake on investment, so as does tax levels, corruption and the extent, whether perceived or actual, of activity by organised criminal gangs in the Russian economy. A recent study, carried out by the World Bank (FIAS) confirms that across the regions, the most often quoted Russia-specific obstacles hindering business development remain : (i) the lack of a functioning secondary private market for land, in particular the observation that regional governments tend to abuse the role of the state as the most important land owner to intervene in investment decisions; (ii) the tax regime, in particular the discretionary power imbedded in tax inspectors, since it is possible for the tax authorities to define arbitrary revenue targets and to enforce them with fines and penalties, as an angle to interfere with business decisions; and (iii) obstacles faced by Russian as well as foreign business which are internationally active : next to the cumbersome regulations enforcing export revenue surrender requirements, reference is typically made to delays and corruption of the customs administration. The EU has urged Russia to consider setting a clear deadline for achievement of the following reforms, which it considers would contribute to Russia's own objective to promote greater investment within a stable, transparent and non-discriminatory framework:

- relaxation of existing limits on foreign investment in certain economic sectors (e.g. insurance, aircraft, energy, alcoholic drinks);
- improved corporate governance, with legislation to define and enforce property rights, especially those of minority shareholders. (The draft Corporate Conduct Code is a step in the right direction);
- reasonable, transparent and predictable tax laws;
- open registration of real estate;
- speedy bankruptcy procedures;
- a high level of protection of intellectually property rights (IPR).

To have full impact, these changes will need to be accompanied by international accounting and auditing standards, including disclosure if share ownership , the absence of which currently provides a disincentive to enter into joint ventures with Russian companies. In the ongoing negotiations on Russia's WTO accession, the EU has requested that sub-federal legislation, regulations and measures that would be in contradiction to Russia's WTO commitments need to be revised, annulled or otherwise brought into coherence with WTO commitments, in order to ensure the security and predictability of access to the Russian market.

Direct foreign investment limitation

- **Local content limitation**

The law "on Production Sharing"¨ places obligations on foreign investors to ensure 70% of local content for production and other equipment used in energy exploration, production and distribution projects.

- **Insurance - Ownership restrictions**

The Russian insurance legislation, the Federal Law No.204-F3 of 20 November 1999 "on the Introduction of Changes and Additions in the Law of the Russian Federation on the Organisation of Insurance in the Russian Federation" introduced several stringent restrictions on the access of foreign insurers to the Russian market. The main one is the prohibition for companies with foreign shareholding above 49% to undertake in Russia life insurance, compulsory insurance schemes, compulsory State insurance, insurance of property related to the implementation of deliveries or contractual services for State needs and insurance of property-related interest of State-owned and municipal organisations. Other restrictive provisions pertain to the introduction of a quota limiting at 15% the aggregate foreign participation in the total charter capital of Russian insurance companies, the reservation of the functions of single executive body and chief accountant to Russians citizens, the payment of foreign shares in charter capital, the advance permission to increase charter capital, the requirement of 2 years of experience on the Russian insurance market, reserves and ratio between assets and obligations. Those conditions are hardly soothed by a grandfathering clause that is unclear. The European Commission particularly regrets the current restrictions on the activities of EU investment funds, especially the 49% limit on the shareholding and the impossibility to obtain licences for investment in foreign currency denominated assets and for collective investment schemes. The Commission considers that the Russian 1999 Law on insurance breaches the EU/Russia Partnership and Cooperation Agreement (PCA) . During numerous intensive consultations with the Russian authorities, the Commission has repeatedly urged Russia to comply with their PCA commitments in insurance. No satisfactory progress has been achieved so far. Consultations on this issue are going on.

Foreign equity limitation in the aviation sector

Russian legislation currently limits to 25 % any foreign equity participation in the aviation sector.

- **Tax discrimination**

Services-transport

The Siberian overflight charges, which date back to the Soviet era, have been a longstanding market access issue between the EU and Russia . Indeed, EU airlines flying routes over Siberia (to and from the Far East) are required to conclude so-called "*commercial agreements*" with the Russian national carrier Aeroflot, as a precondition to receive approval for those operations by the Russian authorities. Based on these imposed agreements, the European airlines, members of the Association of European Airlines, are forced to pay, as a condition "sine qua non" to overfly Siberia, € 220 million per year to subsidise their Russian competitor Aeroflot. The Russian side seeks to justify such charges as a form of "*compensation*" to Aeroflot for not using specific routes, or for not being required to land in Moscow (something which Aeroflot would have to do if it were operating the same routes), thus allowing the foreign airline to save the airport fees. The "compensation" payments that must be agreed upon with Aeroflot bear no economic relationship with actual costs, but are calculated in a way which ensures that using the Siberian space is still cheaper for foreign airlines than to circumvent it. The high amount imposed by the Russian measure has a heavily discriminatory character and is detrimental to the competitiveness of EU airlines. In addition, Russia has recently authorised transit services over Siberia without charging for transit to airlines from US, Canada, and Asian carriers (for the new North-South Cross-Polar routes between North America and South Asia). This aggravating fact of discrimination between trade partners amounts to disregarding MFN principle

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