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BRIEFING NOTE

On the

**POLITICAL AND ECONOMIC SITUATION
OF RUSSIA
and EU-RUSSIA RELATIONS**

This note has been prepared for the information of Members of the European Parliament. The opinions expressed are those of the author and do not necessarily reflect the position of the European Parliament.

Sources: *Economist Intelligence Unit (EIU)*
European Commission
Eurostat
Oxford Analytica
World Bank
Reuters
World Markets Country Analysis

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SUMMARY

Since the Soviet Union disappeared Russia has been a state in the process of reconstruction. After 10 years of transition marked by advances in democracy (adoption of a new constitution in 1993, establishment of a multi-party system, holding of free elections), Russia is now in a second phase of reforms, under the impetus of Vladimir Putin. However, the concept of the state is still relatively weak, as is the structure of Russian society as a whole. President Yeltsin was unable to eliminate patronage networks during his years in office and the overlapping institutional structures he created to neutralise his rivals have left a legacy of bureaucratic complexity. Mr Putin has moved to simplify and rationalise this complexity in government and administration but he has also further centralised power. Domestically, his hand has been strengthened by his re-election for another term and by the domination of the United Russia grouping in the Duma. The weakening of local and regional governments and the increasing government influence over the media is eroding the few checks on corruption and bribery which a free press and alternative power centres can provide. The fiscal problems caused by the collapse of the communist state have been solved largely by the sharp rise in oil prices and the revival of competitive domestic production resulting from the currency depreciation. Oil revenues have also been used to dampen discontent in the military and security establishment.

Internationally, Russia has assumed a more central role with its support for the fight against terrorism and has joined or drawn closer to international organisations such as the G8, the WTO and NATO. The difference of opinion with the United States over Iraq has not fundamentally affected its closer relations with the US. However, human rights violations, greater government control of the media and Russian policies in the North Caucasus have drawn international criticism despite the widespread sympathy following the recent spate of terrorist outrages within the Russian Federation.

During the Cold War relations between the European Union and the Soviet Union were not close. Since 1991, however, Russia and the EC, later the EU, have found it in their mutual interest to establish a closer partnership. A Partnership and Cooperation Agreement came into force in 1997. A 'Common Strategy' on Russia was also adopted by the European Council in 1999 aimed at establishing greater consistency in the EU's and its member States' policy on Russia. Bi-annual summits provide further opportunities to strengthen links. However, Russia continues to press for a more fixed institutional arrangement for its relations with the EU. The EU is one of Russia's key economic partners. However, relations between the two partners are still tainted by the situation in Chechnya. EU enlargement, for long a source of tension, has now taken place and a solution has been found to the Kaliningrad transit problem. Russia's commitment to ratify the Kyoto Protocol announced in October 2004 will further help to improve relations with the EU.

The Russian economy has recovered rapidly from the crisis of 1998. Rising energy prices and the depreciation in the value of the rouble have helped to boost economic growth and turn the fiscal deficits into substantial surpluses. Real wages have been rising recently but the fruits of the economic transition have been unevenly distributed. Russia's trade and payments balances have improved as exports flourish but the economy is still highly dependent on energy price movements. International investors have been concerned at the attacks on the oil major Yukos and signs of apparent attempts to redraw the boundaries between the state-owned and the private sectors. However, there is no likelihood of any move to bring large parts of private business under state control

I. POLITICAL SITUATION

1. Institutions

The Constitution of the Russian Federation was adopted by referendum on 12 December 1993. Article 1 states that 'Russia is a State governed by the rule of law'. The separation of legislative, executive and judicial powers is laid down in Article 10. Russia has adopted a presidential system. The Constitutional Court ensures the constitutionality of laws and other legislative acts adopted by the president, the government, the Duma and the Federation Council. The independence of the judicial system is guaranteed in principle by the irremovability and inviolability of judges.

1.1 The executive

The Head of State is Vladimir Putin, re-elected President on 14 March 2004 for a second four-year term. The current Prime Minister is Mikhail Fadkov appointed in March 2004. Under the Constitution, the government exercises executive power. It adopts orders and decrees and has the right of legislative initiative (about half of all laws adopted by the Duma are the result of government initiatives). The Russian government's scope for initiating legislation is however strictly controlled by the President. It is the President who appoints the Prime Minister, with the Duma's agreement, and the President again who appoints ministers, on a proposal from the head of government. The President can remove government members from office. President Putin streamlined the government in 2004 by reducing the number of ministers from 30 to 17 and the number of deputy prime ministers from five to one.

1.2 The legislature

The Russian legislature is bi-cameral, consisting of the 450-member Duma, elected by universal suffrage, and the 178-member Federation Council. The Duma members are currently elected according to a mixed system (225 members elected by proportional representation from party lists and 225 by a first-past-the-post system in single-member constituencies. The Duma ratifies the appointment (by the President) of the Prime Minister, but experience has shown that the President can ensure his candidate is appointed by threatening to dissolve the Chamber. The Duma can table a motion of censure against the government, but the President is not obliged to comply with it. It can challenge the President but only if it is able to muster a two-thirds majority. The Duma adopts decrees which fall within its field of competence and votes on laws, in particular the budget, but the President can veto them. The Duma's powers, are thus relatively limited, and political practice in recent years has shifted the balance of power further in the President's favour.

The powers of the Federation Council are also relatively limited. Initially, elected regional governors and the heads of regional assemblies were *ex officio* members of the Council but, under a law passed in 2000, they are no longer automatically represented. Instead, the regional executives and legislatures of the 89 'federal subjects' each elect a representative. The composition of the Federation Council therefore changes with every local election. In practice, it is by its very composition much more closely linked to the executive, as the vast majority of regions depend on subsidies from the centre and it is therefore not in their interest to oppose it. The Federation Council, apart from voting on the laws adopted at first reading by the Duma, is responsible for all matters affecting the Federation and relations between its

different subjects. It provides a forum in which the different regions can negotiate and find compromises with each other and with the government. A State Council was set up by way of compensation for former Federation Council members, but this is an advisory body which allows regional governors access to the President but has few powers.

1.3 The judiciary and legal system

The supreme judicial body is the Constitutional Court, which rules on cases concerning compliance with federal laws, the constitution, statutes and state treaties. The Supreme Court is the highest authority in civil, criminal and administrative matters. A Supreme Arbitration Court and lower courts of arbitration hear most commercial and business cases. Judges in these higher courts and the prosecutor-general are nominated by the President subject to the approval of the Federation Council.

Politicisation of the judicial system is still a problem. The Constitutional Court does not consider 'political' cases, with the result that some breaches of constitutional provisions, notably those involving the division of powers and corruption at state level, are unchallenged. At other levels there have been instances of cases where judgements have reflected political rather than legal considerations, notably in 2002, when damages suits filed by victims of the Moscow Nord-Ost Theatre hostage crisis were dismissed outright. However, the increasing use of trial by jury and other reform measures are expected to have a positive influence, at least on the administration of criminal justice.

During his first term of office, President Putin reactivated efforts to reform the judiciary. These had made little progress since initial attempts in the early 1990s were hampered by a combination of resistance from within the procuracy and judiciary itself, bureaucratic inertia and a lack of proper funding. A reform package was launched in 2001 on the basis of proposals put forward by a reform commission chaired by Dimtii Kozak, the head of the Presidential administration's legal department. The package covered three main areas. The first aimed to modify the status of judges. Until now irremovable and appointed for life by presidential decree (which was meant to guarantee their independence), the presidents of the various courts will have their terms of office limited to six years. Their appointment will no longer require the assent of regional parliaments, and new mechanisms governing disciplinary and penal sanctions will be introduced. The second section covers revision of the code of criminal procedure, the code of civil procedure and the arbitration code, which covers economic and commercial cases. The third consists of precisely defining lawyers' rights and remits. According to its authors, the aims of this threefold reform were as follows: to limit the excessive powers of the public prosecutor's office, to strengthen and guarantee the rights of the defence in the face of 'judicial bureaucracy' and to make the functioning of the judicial system, which is at present too heavily influenced by local authorities, more uniform. However, it was not until the beginning of 2003 that the government announced a substantial increase in funding to allow the reforms to be properly implemented.

The new Code of Criminal Procedure has been in force since July 2002. It establishes such principles as the presumption of innocence of a defendant until guilt is proved, the right to free legal advice and bail, and imposes limits on detention without charge. The Code also transfers responsibility for arrests, warrants, searches and detention from the government-controlled procuracy to the judiciary. Trial by jury, a constitutional right since 1993, is now a real option in all parts of the Federation, except Chechnya. Judges' salaries have been increased substantially and computerisation of the judicial process is increasing. New law schools have been established and better training is being provided in conjunction with a number of international organisations.

1.4. Political parties

After the collapse of the USSR, a multitude of political formations came into being. No fewer than 43 parties took part in the 1995 general election. However, more recently, the situation has begun to stabilise. Only 28 parties contested the 1999 election, and only six of them cleared the threshold of 5%. In the 2003 elections, 23 parties registered and nine of them won seats, but only two of these had a distinct ideology and a solid well-established party structure, namely the liberal Yabloko party and the Communist Party. Other parties tend to be loose groupings which provide a power base for prominent figures. The most obvious examples are the United Russia party, which supports President Putin, and Vladimir Zhironovsky's Liberal Democratic Party of Russia.

A key force Russian political life is the existence of political "clans". Of these, the *siloviki* - members of the security services, the military and the police - is the largest group, estimated to hold more than 60% of positions of power according to a study published in 2003. Although not a coherent group, the *siloviki* share a belief in the need for a strong state and distaste for the wealth and power acquired by the business elite. Another, smaller group is the "St. Petersburg liberals" led by Economics Minister German Gref and Finance Minister Aleksei Kudrin.

Following his election in 2000, Mr Putin appealed for political reform, advocating a two- or three-party system. A law on the organisation of political parties, backed by the Russian President, was adopted in 2001. Its provisions were aimed at keeping a handful of large parties (three to five). To be authorised, a party is supposed to have at least 10 000 members and to have regional sections with at least 100 members in more than half of the 89 regions of the Russian Federation. The Central Electoral Commission has announced that it intends to submit proposals to hold the next Duma elections in 2007 under a fully proportional system which, if adopted, would eliminate the single-mandate constituencies in favour of a pure party list system.

2. Recent developments in domestic politics

2.1 The elections to the Duma

The Duma elections of 7 December 2003 strengthened President Putin's grip on parliament. The United Russia party, which is close to the President, polled 38% of the vote and gained 222 of the 450 seats. Although the ruling forces were able to use their influence over the media and other assets, President Putin's personal popularity was also a contributory factor to United Russia's success. The Presidential majority in the Duma has been strengthened by the defection to United Russia of deputies elected on other party platforms.

The Communist Party (KPRF) came second in the polls, but its support in the list vote, at 12.6%, was only half the level polled in the 1999 elections. The party appeals mainly to an older electorate and has not captured the imagination of the younger generation. It also suffered in the elections from damaging splits in 2002, with the expulsion of a number of party leaders who refused to follow the harder anti-Kremlin line, including the Duma Speaker Gennady Seleznev, and, in 2003, with the defection of prominent left-winger Sergei Glazev to set up his own party. The splits in the party have continued. In July 2004, a rival party congress was held at the same time as the official

KPRF congress. KPRF leader Gennady Zyuganov succeeded in having the rival congress declared illegal and a number of senior figures who took part have since been expelled from the KPRF.

Nationalist parties did better than expected. The Liberal Democrats (LPDR), led by Vladimir Zhirinovskiy, surprised analysts by polling 11.5% to put it in third place. The party's far right positions on issues such as immigration appeal to protest voters. Motherland (Rodina), formed in August 2003 by Sergei Glazyev and Dmitry Rogozin, also did well, polling 9% on a nationalist and socially-oriented platform. However, disagreements between the two leaders over the decision by Mr Glazyev to run in the Presidential election led to a split. Mr Rogozin now leads Rodina in the Duma, while Mr Glazyev now leads another grouping called "For a Dignified Life". Rodina has recently set up a coordination council with the KPRF to improve their cooperation in parliament.

The two main liberal parties, Yabloko and the Union of Rightist Forces (SPS), failed to pass the 5% threshold for parliamentary representation but gained a number of single-mandate seats. However, many of their deputies subsequently joined the United Russia faction in parliament. Yabloko is led by Grigory Yavlinsky and mainly draws its support from the impoverished and disillusioned intelligentsia, while the SPS, led by Anatoly Chubais, is widely regarded as the party of the oligarchs. The decline of these two Westernised, market-oriented parties has shifted the balance of power in Russian politics with opposition now largely confined to nationalist or social-democratic groupings.

2.2 The Presidential election

In the Presidential election of March 2004 Mr Putin obtained 71.3% of the votes cast to put him well ahead of his nearest rival, Nikolai Kharitonov of the Communist Party on 13.7%. The three other candidates each polled under 5%. The turnout, at 64.4%, was slightly less than the 68.6% recorded in 2000. The wide margin of Mr Putin's victory provoked considerable international criticism of the conduct of the election. The main criticisms concerned Mr Putin's massive support from the mainly state-controlled media rather than the actual conduct of the ballot.

Mr Putin's victory, combined with the success of the United Russia Party in the December 2003 legislative elections, has increased his dominance of the political scene. Following his re-election Mr Putin was quick to reshuffle the government, replacing the Prime Minister, Mikhail Kasyanov, by Mikhail Fradkov, a technocrat who had been Russian ambassador to the EU. The cabinet was also streamlined as part of a wider process of reform of government and administration.¹

2.3 The internal security situation and the Northern Caucasus

The situation in the North Caucasus continues to dominate the headlines. Terrorist attacks by Chechen radicals reached a new level in the third quarter of 2004. Three suicide attacks killed over 100 people, while the attack on a school in Beslan, North Ossetia, on 1 September 2004 and the subsequent hostage-taking and siege resulted in at least 338 deaths. The attack in Beslan took place only a few days after the presidential election in Chechnya called following the assassination of the former president Akhmad Kadyrov in May. In June 2004, a series of federal installations were attacked simultaneously in neighbouring Ingushetia by Ingush and Chechens, as well as people

¹ See section for further details.
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from other parts of the region and beyond. Ingush rebels declared a *jihad* on 8 July, not only on the territory of Ingushetia but also in a traditionally Ingush area of North Ossetia.

Chechen resentment of Russian rule is long-standing. Stalin, who greatly mistrusted them, deported 350 000 Chechens to Central Asia. It was only in 1957 that the Chechens were rehabilitated and given permission to go home. The current Chechen crisis dates back to November 1991, shortly before the collapse of the USSR, when the new Chechen Parliament declared independence. Russia was unable to react immediately to this challenge but, in December 1994, President Yeltsin sent the Russian army into Chechnya to 'respond to the threat to Russia's territorial integrity and the security of its citizens'. The Chechens resisted successfully and Russia signed a peace agreement in August 1996. However, Russia could not accept Chechen independence, as it could set an example which might be contagious and threaten the Federation's territorial integrity. Another factor was the expected benefits from the transit of Azerbaijani oil through the pipeline which crosses Chechnya via Dagestan. Russian troops re-entered Chechnya on 21 October 1999 when Mr Putin was Prime Minister, following a series of attacks in Russia and, since then, there have been periodic attacks by Chechen separatists, notably the Moscow theatre siege in 2002. The Russian forces decimated the Chechen separatist forces, capturing or assassinating military commanders and opposition leaders. However, this and the Russian government's refusal to consider a political solution have pushed the Chechen rebels towards terrorism. Although most attacks have been against federal targets inside Chechnya, cities in Russia and other parts of the North Caucasus have also been targeted.

At the first meeting of the government following Beslan, which was chaired by President Putin, a new approach to the Northern Caucasus was decided based on tighter security and economic development. Dmitry Kozak was appointed as presidential envoy to the region. At the same time, the government also decided to adopt a tougher internal security policy and a more nationally-oriented foreign policy. President Putin was quick to announce new anti-terrorism measures. More than 29 amendments on security, law enforcement and counter-terrorism have been tabled for debate in the new session of the Duma. The measures include stricter visa requirements for foreigners; resident registration in cities and major industrial centres and tracking of the transfer of vehicle ownership. The government has agreed to the holding of a joint parliamentary inquiry into Beslan, which is expected to lead to further security restrictions. Civil liberties are likely to be the main casualties of such a crackdown.

While tight security remains central to policy in Chechnya, the victory of Alu Alkhanov in the Chechen Presidential election held at the end of August 2004, in which he obtained 74% of the votes cast on a turnout of 79%, has opened the way for the second strand of Moscow's approach to the Chechen problem - a business-friendly economic policy to help create a new business elite. The idea is to shift national aspirations for independence from the political and military sphere to the economic. The Chechen authorities have been lobbying for a programme of economic revival. This would include greater fiscal independence, a special customs regime and the setting up of a special economic zone (the latter has existed *de facto* since 2003 but the corresponding federal law has not yet been passed and faces opposition from the Ministry of Finance). The third strand of the new approach, re-establishing ties with the Islamic world, will also be a priority for the Chechen authorities and fits into Russia's new overall strategy of engagement with the Arab world.

The recent terrorist attacks have exposed further weaknesses in Russian security services. Changes had already been made at senior level in the Ministry of Defence, MVD and Federal Security service (FSB) following the series of attacks against MVD and border guard installations in Ingushetia in June 2004. Lack of coordination and overlapping responsibilities among the various security agencies are a major concern. In response to these failings, a number of new measures have been taken. Security forces in the North Caucasus have now been reorganised, with joint operational groups in all 13 areas headed by a representative of the Ministry of Internal Affairs (MVD) with military experience of Afghanistan or Chechnya. The groups form part of a federal network led by the Federal Anti-terrorist Commission. All the security services may be merged in a re-formed KGB and the creation of a joint intelligence analysis centre is under consideration. As corruption is also considered by the government to have been one of the factors in the Beslan tragedy, senior regional police and security officials have been sacked as part of a drive against corruption.

At the international level, Russia is keen to see joint action against terrorism. The general support given by the UN Security Council to Russia in the Beslan crisis is considered as providing Russia with a potential legal basis for pre-emptive action against terrorism. The possibility of a pre-emptive strike in Georgia was raised in 2002, when Russia alleged that it had allowed Chechen fighters on its territory. and, in 2003, the concept of pre-emptive strikes against terrorists was put forward by the Defence Minister, Sergei Ivanov. However, this is clearly a policy of last resort requiring as it does a presidential order and UN authorisation. At the same time as calling for more international cooperation against terrorism, Russia strongly resists any foreign interference in domestic affairs, particularly Chechnya.

Russia has been repeatedly criticised for its policy in Chechnya. On 3 July 2003, the EP adopted a resolution² stating that in its view the persistent and recurrent infringements of human rights by Russian forces in Chechnya were war crimes and crimes against humanity. Parliament called on both sides to reach a cease-fire and asked Russia to accept in its entirety the extension of the OSCE mandate. The Parliamentary Assembly of the Council of Europe, concerned by the situation, even suspended the rights of the Russian delegation for several months. The Council of Europe has called for the creation of an International Criminal Tribunal (ICT) for the crimes committed in Chechnya. The decision was a purely symbolic one, however, as the establishment of an ICT is subject to authorisation from the UN Security Council, on which Russia has a right of veto. NGOs such as Human Rights Watch and the International Federation of Human Rights Leagues (FIDH) have also condemned the increasing deterioration of the human rights situation. Moreover, for the first time, on 16 January 2003 the European Court of Human Rights declared admissible six applications against Moscow by Chechens who are accusing Russian soldiers of torture, inhuman and degrading treatment and infringement of the right to life.

However, on the whole, the international community has been rather muted in its criticism of Russian policy in Chechnya. The OSCE left the country in March 2003, at Russia's request, and the UN failed to exercise any coercive power, its agencies confining themselves to humanitarian activity. On 16 April 2003 the UN Commission on Human Rights refused for the second year running to adopt a resolution condemning Russia for the crimes committed in Chechnya. The EU-Russia St. Petersburg summit of 31 May 2003 finally resulted in a joint statement which only made a passing reference to the situation in Chechnya. The reference was neither stern nor binding and

² See minutes of sitting of 3 July 2003.
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ignored the condemnations by human rights organisations of the crimes committed by the Russian army.

The US-led "war on terror" has also shifted the international focus. The attacks of 11 September 2001 allowed President Putin, with some success, to draw a parallel between al-Qa'ida terrorists and Chechen separatists. The attack on the Moscow theatre in 2002 also made it easier for the Russians to isolate Mr Maskhadov (leader of the Chechen party), by placing his party on a par with al-Qa'ida, and to rule out all prospects of political negotiations with the Chechen party. However, despite the enormous sympathy following the Beslan tragedy, calls for a political settlement of the Chechen problem have again come to the fore.

2.4 The Yukos affair and the oligarchs

The Chief Executive and founder of the Yukos oil company, Mikhail Khodorkovsky, was jailed in October 2003, a move seen by many as an attempt by the Kremlin to counter his political ambitions and his challenge to the government's energy sector policy. In August 2004, Yukos was found guilty of tax evasion and fined Rb 99.4 billion (US\$ 3.4 billion). Yukos issued a bankruptcy warning. Additional claims have since been announced. International capital markets are worried that Yukos might be forced to sell off its main subsidiary Yuganskneftegaz in order to pay the fine, possibly to a state-controlled consortium, concerns that have now been conformed by recent media reports. The ongoing uncertainty has undermined investors' confidence in Russia as a place to do business.

At another level, the move against one of the leading oligarchs can be seen as part of Mr Putin's policy of eliminating the oligarchs as a class, thus fulfilling one of his electoral promises. The action against the oligarchs has been selective. The first moves were against media tycoons such as Boris Berezovsky and Vladimir Gusinsky, whose influence over the mass media gave them considerable political influence. Mr Khodorkovsky is in a different category but he had been one of the few prominent figures in Russia to openly criticise the Kremlin. He had also used some of his fortune to fund opposition parties. Although his arrest and the raids and prosecutions against Yukos are related to illegalities in past privatisations and tax evasion, and President Putin takes the line that he cannot interfere with the judicial process, there is little doubt that the campaign against Yukos is also politically motivated. While the President has ruled out large-scale re-nationalisation of privatised property, the threat of further investigations into the past actions of other oligarchs is likely to encourage them to keep a low profile politically, at least in the short term. Moves against the oligarchs are also likely to be popular among large sections of the electorate disillusioned with the negative impact that the uncontrolled liberalisation of the 1990s has had on living standards of the population in general compared with the huge fortunes amassed by the few.

2.5. Human rights

Article 2 of the Russian Constitution states that: 'Man, his rights and freedoms shall be the supreme value'. By joining the Council of Europe on 28 February 1996, for reasons which were more political than legal, Russia committed itself to bringing its legislation into line with the Council's legal rules. In May 1998, Russia signed the European Convention on Human Rights and the Convention against Torture and suspended the death sentence. However, there are still grounds for

concern as freedom of expression and respect for minorities appear to be increasingly under threat. There are still reports of police use of torture despite the adoption of the new criminal court and, although the new procedures have reduced the number of arrests, ethnic minorities are still disproportionately targeted for identity checks and face arbitrary detention and deprivation of procedural rights.³ The situation in Chechnya and Ingushetia has been well documented by human rights organisations such as Amnesty International and Human Rights Watch, with numerous allegations of torture, rape, extrajudicial killings and “disappearances”.

Freedom of expression, the key achievement of the Yeltsin era, is becoming increasingly restricted. In April 2001, Gazprom, considered by observers to be on of the arms of the Kremlin, took control of the private TV channel NTV and the Moscow independent radio station *Echo*, the leading station for news and political debates. The daily paper *Sevodnya* was also closed and the editorial staff of the weekly magazine *Itogi* were fired. In January 2002 the liquidation of TV-6, the only remaining independent TV channel, deprived the Russian broadcast media landscape of its only dissenting voice. TV-6 was given renewed authorisation to broadcast on 27 March 2003 but under Kremlin supervision. During the night of 22 June 2003, the last independent Russian TV channel, TVS, was closed by order of the Ministry of Information. This meant that in the run-up to the Duma and Presidential elections, Russians were left with only three general-interest TV channels, two state-owned and the third controlled by Gazprom.

2.6 Public administration reform

Following the government reshuffle in March 2004, the Russian authorities announced plans to restructure the Federal Government that are more radical than most commentators had expected. The measures reduce the number of different types of government bodies to just three: ministries, services and agencies. All services and agencies are subordinated to a specific ministry. The number of ministries has been reduced from 23 to 15, of which 5 report to the President and 10 to the Prime Minister, and the number of Deputy Prime Ministers has been cut from 6 to 1. However, overall, the number of government bodies has actually increased from 57 to 72. The number of deputy ministers in each ministry has also been cut as have the Moscow-based staffs of ministries. The number of staff in the Presidential administration has been cut from 1500 to 1200 and overall numbers of federal civil servants have been reduced from 19 000 to 17 000. The savings have been used to fund pay increases for ministers and civil servants at all levels. Federal institutions as a whole are to lose 30% of their staff over the next two years. Large cuts will also be made in the staffing levels of regional-territorial departments and executive institutions.

However, there was no consultation or advance preparation for the changes, so that altering the behaviour of public servants and institutions may take much longer in practice. The process of aligning the structures and functions of government with its key objectives and priorities will have to be completed at all levels and new incentive and accountability systems will be devised and introduced. Transparency, external accountability and participation will also need to be strengthened and adequate budgetary resources will have to be allocated to support the reforms.⁴

On 11 August 2004, President Putin signed the **federal law on the state civil service**. This sets out the principles of the civil service, the status, obligations, certification and salaries of officials, their functions ranks and posts, as well as recruitment procedures and requirements. A few weeks before

³ Human Rights Watch, Human Rights Overview, January 2004

⁴ World Bank, Russian Economic Report, June 2004, pp. 12-15

the President set up a special commission on improving public administration which will draft proposals on elimination duplication of executive agencies, limiting intervention in business activity and halting excessive regulation. The new regulations will also standardise on the same basis as the federal civil service the recruitment and assessment procedures for regional staff. The rotation principle for civil servants is also being reintroduced so that officials will move between federal and regional bodies. This is to be seen in the context of wider moves to subordinate the regions to the federal government.

3. Foreign policy

3.1 Relations with international organisations

Russia is a member of the UN (USSR, 1945), the OSCE and the Council of Europe (1996). It is also a member of the Council of Baltic States and of the Black Sea Economic Cooperation Area and is a founder member of the CIS (1991). It is also a signatory of the NATO Partnership for Peace (Founding Act) and a member of the NATO-Russia Permanent Joint Council (1997).

3.1.1. CIS

The Commonwealth of Independent States (CIS) was established in Minsk on 8 December 1991 by the Russian, Belarusian and Ukrainian presidents. Since 1993 (when Georgia joined), it has brought together 12 of the 15 former republics of the USSR⁵. For the Kremlin, the former Soviet Republics are a special area of interest where, because of long-standing economic, human and cultural links, Russia has not only permanent interests but also a particular responsibility. As well as any coordination, or even integration, deemed necessary by Russia in military, economic or diplomatic spheres, Russia claims the special role of ‘guarantor of peace and stability’ for the whole area. The ‘near abroad’ concept neatly sums up this vision of relations between Moscow and its former dependencies.

To help achieve this goal, on 31 May 2001 Russia launched a Eurasian Economic Community with Belarus, Kazakhstan, Kyrgyzstan and Tajikistan. In addition, on 25 May 2001 the members of the ‘collective security pact’, which brings together Russia, Belarus, Armenia, Kazakhstan, Kyrgyzstan and Tajikistan, created, in the name of the ‘fight against international terrorism’, a rapid reaction force to respond to incursions in Central Asia by Islamic extremists. However, the RRF has proved ineffective as a joint task force. Cost constraints have limited its mobility and the battalions assigned to it remain deployed in their countries of origin with the exception of the Russian 201st Division in Tajikistan. In 2003, a new initiative led to the establishment of the Collective Security Treaty Organisation (CSTO). For the first time, its charter includes a mutual defence clause.

Recently, President Putin has admitted that the grouping is in difficulties. In July 2004, the President stressed the urgency of dealing with problems in the CIS area, saying that the organisation was on the threshold of either strengthening itself into an effective institution, or dissolution. On 30 July, President Putin named the Energy Minister, Viktor Kristenko as his special advisor for the

⁵ The 3 Baltic States refused to join.

CIS. The list of Russian priorities for the region includes combating international terrorism, transnational crime and illegal migration; curbing the illegal proliferation of arms and drug trafficking

3.1.2. NATO

Since the 1990s, the geographical enlargement of NATO in Europe has progressed contrary to the wishes of Russia's leaders. NATO membership has now expanded to include ten countries from central and eastern Europe, notably the three Baltic states, Estonia, Latvia and Lithuania. Albania, Croatia and FYROM have also announced recently that they intend to seek membership of the Alliance. In practice, NATO's enlargement has not so much threatened Moscow, as highlighted its diminishing influence on the world scene, particularly compared to the United States. Post-Communist countries which join NATO leave the sphere of Russian economic, political and social influence and enter that of the United States. To overcome Russian opposition to NATO expansion, the Atlantic Alliance set up discussion and cooperation forums. In January 1994, it created the Partnership for Peace, providing a link between Western countries and those of the former USSR, with the exception of Tajikistan. In May 1997, NATO signed a Founding Act with Russia which provides for the establishment of a 'strong, stable and enduring partnership' between the two parties, but which rules out the right of veto over the decisions of the other party. A Permanent Council for Consultation and Cooperation is to provide a forum for dialogue. As soon as he came to power, Vladimir Putin reviewed Boris Yeltsin's 'empty chair' policy with regard to NATO.

11 September 2001 was a key turning point in relations between Russia and NATO. The prompt support given to President Bush⁶ was an indication of Russia's desire to move closer to NATO and the West. Since then, Russia and NATO believe that mutual rapprochement is in their common interest. The political will of both sides was embodied in the announcement on 14 May 2002 of the establishment of a Russia-NATO Council⁷. If no consensus can be reached among the 20, the 19 meet amongst themselves to try to reach that consensus. Russia therefore still has no right of veto, but hopes to gain further powers in the Alliance and in the future structure of European security.

3.1.3. G8

Russia achieved full-member status of the G8 on 26 June 2002, at the Kananaskis summit. This can be seen in some way as the reward for the wave of economic reforms and Russia's alignment with western countries in the fight against terrorism. Russia sees the G8 as a key international forum in which to develop its global status. It is set to chair the grouping in 2006.

3.2 Regional and wider international relations

3.2.1. Belarus, Ukraine, Moldova

Russia maintains close relations with Belarus, whose President, Mr Lukashenko, is its most loyal ally. In December 1999, the two countries signed a Treaty of Union. On 31 May 1997, Ukraine and Russia signed a Friendship and Cooperation Agreement, to run for six years. This Agreement was possible thanks to the settlement of the dispute between Russia and Ukraine over the division of the Black Sea Fleet and the withdrawal of Soviet nuclear weapons stationed in Ukraine. Russian influence in Moldova

⁶ Vladimir Putin was the first head of state to contact George Bush after the attacks of 11 September 2001.

⁷ Also known as the 'Nato at 20' format.

suffered at setback in November 2003 when a deal which would ensure the presence of Russian troops until 2020 fell through.

3.2.2. South Caucasus

Russia, the EU and the US are all interested in this region because of its oil and gas reserves. Russia has traditionally maintained close relations with Armenia, which, surrounded by hostile neighbours (Turkey and Azerbaijan), has always sought Moscow's support. However, relations with Georgia are more difficult (in view of its support for the break-away movements in Abkhazia and South Ossetia), as are those with Azerbaijan (given Russian support for the Armenians during the Nagorno-Karabakh conflict). Relations with Georgia became more strained throughout 2002 and, on 12 September 2002, President Putin demanded from the UN and the OSCE the right to take military action in Georgia, which it accused of sheltering Chechen terrorists in the Pankisi Gorges. Russia aims to retain considerable influence in Georgia, a country of great geo-strategic importance in which the United States would like to play an increasing role⁸. However, the fall of President Shevardnadze in 2003 and the ascendancy of the pro-Western Mikhail Saakashvili has made any increase in Russian influence considerably less likely. Initially, Russia supported the new regime and was instrumental in negotiating the removal of the Adjarian leader, Aslan Abashidze, in May 2004. This was a major policy shift, as Russia had traditionally supported separatist forces in the Georgian regions of Adjara, Abkhazia and South Ossetia. However, following further violence in South Ossetia in recent months, relations between Russia and Georgia have cooled, with both sides accusing each other of increasing tensions in the region. President Saakashvili has been trying to widen and internationalise the arena for conflict mediation in order to minimise the Russian role in the area. Although the US has been strongly supportive of President Saakashvili and has increased its military support and advisory role, it has also urged him to pursue a bilateral approach with Russia to solving the problems in the region. Russia also seems to be approaching the problem more tentatively and has not responded militarily to recent actions by Georgian troops in South Ossetia. Encouragement of South Ossetian separatists might send the wrong signals to independence movements in other parts of the Caucasus. The US and Russia are also keen not to prejudice their improved cooperation on other issues by confrontation in the Caucasus.

Relations between Russia and Azerbaijan – rich in gas and oil – are better. Baku has accepted the presence of Russian border guards in the name of the 'fight against international terrorism'. Moreover, President Heydar Aliyev's visit to Moscow at the end of September 2002, enabled an official agreement to be drawn up on the status and division of the Caspian Sea, which is extremely rich in oil and natural gas.

3.2.3. Central Asian Republics

In the formerly Soviet part of Turkestan, Moscow maintains excellent relations with Kazakhstan, Kyrgyzstan and, above all, Tajikistan. Russia's relations with Turkmenistan and Uzbekistan are less close. However, the situation following the terrorist attacks in the United States, has united Moscow and the five Muslim republics against a common enemy: Islamic terrorism. President Putin gave the go-ahead to the Americans to use Russian military bases in the former Soviet republics of Central Asia during the war in Afghanistan. Central Asia remains relatively dependent on Russia, with

⁸ This role is necessary because of the opening – scheduled for 2005 – of the Baku-Tbilisi-Ceyhan pipeline, which will transport Caspian oil to Turkey. This project has been financed by Anglo-American firms.

which it conducts most of its trade. It still, therefore, falls to a large extent within the Russian sphere of influence.

3.2.4. China and Japan

China has been one of the principal focal points of Moscow's new foreign policy. Russia and China share foreign policy interests with regard to the US and Japan and have similar concerns over Islamic fundamentalism in Asia, which they fear may spread to Moslem communities within their borders as has happened in the Caucasus. On 16 July 2001, Russia and China signed a friendship treaty valid for 20 years. The two countries, together with Kazakhstan, Kyrgyzstan, Uzbekistan and Tajikistan, also belong to the Shanghai Group, whose goal is to combat terrorism, separatism and extremism. Both China and Russia have been accused of using the war on terror to perpetrate human rights abuses and both have responded by accusing their critics of applying double standards.

Energy supplies are also a major issue in Sino-Russian relations. China is anxious to secure Russian approval for an oil pipeline from Angarsk in Siberia to its Daqing oil refineries. But Russia is also being lobbied by Japan which would like the pipeline to follow the much longer route from Taichet to the Japanese port of Nakhodka. Both China and Japan have offered Russia large investments in return but no final decision has yet been taken. Relations between Japan and Russia were never close during the Cold War because Japan's links with the US and the long-running dispute over the sovereignty of the southern Kuril islands also contributed to this distance. Russia's trade relations with Japan are modest compared with its relations with China.

3.2.5. United States

Despite some disagreements, Russia and the US are moving closer in areas such as counter-terrorism and non-proliferation. Russia's support for the US "war on terror" in the aftermath of September 11 came as a surprise to most observers and strengthened Russia's geostrategic position. President Putin defied internal opposition to this policy switch. He was quick to realise that the war on terror would divert US attention from Russian domestic issues and its policy in the CIS countries. Among the immediate benefits was US backing for the new NATO-Russia Council, set up in 2002 as part of upgrading of the NATO-Russia dialogue, and support for Russia's WTO membership application. Russia also occupied a higher place on the US foreign policy agenda because of its potential as an ally in Afghanistan and as a major alternative energy supplier to the increasingly unstable Middle East. For its part, Russia began to soften its tone on NATO enlargement and the US ballistic missile programme. It also offered logistical and intelligence assistance, sharing data on Afghanistan, increasing arms supplies to the Northern Alliance and allowing coalition aircraft to use bases in Central Asia. A US-Russian working group on terrorism and WMD was set up in 2001, and it has emerged recently that, in 2002, Russian intelligence services (SVR) passed on information on Iraqi plans to organise terrorist attacks against US targets. The SVR also provided information on potential terrorists. The US backed a Russian proposal to set up an OSCE observation mission in the Pankisi Gorge in Georgia.

In the area of WMD, Russia shared information on the Iranian and North Korean programmes and joined the US-sponsored Proliferation Security Initiative (PSI) joining the US in submitting a draft resolution to the UN Security Council aimed at securing wider support for the initiative.

However, despite these various initiatives and instances of increased cooperation, US-Russian relations are still not the strategic partnership to which President Putin aspires. In both countries some circles are still mistrustful, and recent trends towards a more authoritarian approach in Russia have undermined the belief in President Putin's democratic Westernising credentials. However, most of the criticism has

come from the US Congress rather than the White House, and key US investors seem to be treating the Yukos crisis as an isolated case.

In addition, President Putin has maintained Russia's agreements – and even signed new ones – with certain 'Axis of Evil' countries. With regard to the contracts signed with Iran, the IAEA (International Atomic Energy Agency) noted on 16 June 2003 that Iran was not complying with the Non-Proliferation Treaty (NPT) by failing to report the use of certain materials and nuclear activities. The US strongly criticised this cooperation by accusing Iran of attempting to develop nuclear arms. Moscow stated that it would continue its cooperation with Tehran after obtaining assurance that Iran intended to sign the additional protocol to the NPT. In 2003, Russian exports of nuclear technology and radioactive fuel were estimated to be worth US\$ 3 billion. Russia holds 35% of the world market in enriched uranium and, according to the Russian Government, the US is trying to reduce the Russian nuclear sector's world outlets.

The main point of US-Russian tension over **Iran** centres on the Bushehr nuclear plant. Around 1 500 specialists from Russia and CIS states are advising on its construction and the project has been financed by Russia. However, the US fears the plant may allow Iran to develop a nuclear weapons programme, while Russia insists it will only allow nuclear energy to be developed for peaceful means and that the plant will be completed only if Iran returns all spent nuclear fuel to Russia. The Bushehr plant is potentially worth US\$ 1 billion to Russia after it is completed, probably in 2006. This is likely to be paid back to Russia in instalments. In August 2004, the head of Iran's Atomic Energy Organisation announced that Russia had contracted to build more nuclear reactors. Bilateral trade with Iran totalled US\$ 1.4 billion in 2003, mainly in the form of Russian exports of industrial and military equipment. Increased energy cooperation has also led to a system of oil swaps between Russia and Iran. The relationship with Iran is seen by Russia as part of its external economic policy and as an opportunity for Russia to act as mediator with Iran on the international stage.

Russia's alignment with the Franco-German position on the **Iraq** war may have upset Washington but has probably not affected their longer-term relations. Moscow had a long tradition of cooperation with Baghdad, including a number of major oil projects. In general, Moscow's agreements with 'rogue states' have had a slight effect on relations with the US and President Putin has not sought to further provoke American wrath. Whilst condemning the war in Iraq to avoid upsetting the Russian public, the president has been anxious to maintain close cooperation with the US and has been moderate in his choice of words. Moscow and Washington have re-launched the idea of the strategic partnership announced by the two countries after 11 September 2001, which included cooperation in oil matters. The US has also helped Russia in its bid to join the WTO.

II. ECONOMIC SITUATION

1. Introduction

In 1992, Russia opted for a policy of rapid conversion to a market economy. The broad lines of the macroeconomic policy introduced by Yegor Gaidar as Prime Minister in 1992 have largely been followed by succeeding governments. The State began by dismantling the Soviet planned economy system. Price liberalisation, macroeconomic stabilisation and integration with the world economy have been the main objectives. Appropriate monetary and fiscal policies have been adopted although not always implemented. However, governments have tended to avoid micro-economic structural reforms for fear of their social and political consequences. Privatisation has in general been rapid but tended to benefit those close to the presidential administration and banks linked to the MIC⁹ or to the oil and natural gas sector, marginalising the entry of non-Russian players into the few sectors in which they were interested.

Huge fortunes were amassed from common assets which were carved up. The president of the Court of Auditors, Mr Stepashin, recently published a report showing that 90% of privatisations carried out since 1994 had been illegal. Yet it is not certain that, had other choices been made, the real challenges would have been overcome smoothly. The Russian leaders at the time clearly did not assess all the consequences of opening up the market. The reasons for the economic crisis of August 1998 are to be found in the weakness of the State, incapable of controlling complex mechanisms, rather than in a lack of experience or abuse of authority on the part of the players involved. Criminal practices did occur in some sectors and some of those responsible were put on trial. However, it is probably true to say that the majority merely profited from the failings of a legal system which was still in the process of being constructed.

The economic crisis and uncontrolled liberalisation have increased inequalities within society. The gap between the 'new Russians' and marginalised groups (such as pensioners and civil servants) has widened dramatically. A report by the Committee for Statistics of 18 September 2001 showed that 45.2 million people (31% of the Russian population) live below the poverty line, estimated at 1507 roubles (51 dollars) a month. However, poverty cannot be measured solely in terms of very low salaries, for it is also a result of the decline in public services. Education, health and housing have all deteriorated through lack of funding, worsening the situation for most of the population.

2. Recent economic trends and future prospects

Since the crisis of 1998, governments have held down federal spending and this, combined with rising exports following the sharp rouble devaluation and sustained high world oil prices, has helped to ensure average annual GDP growth of almost 6.7% in the period 1999 to 2003. Russian businesses have been able to restore their competitiveness on the internal market, helped also by the sharp drop in wage costs and the price reductions imposed on monopolies. Inflation fell to around 20% by the end of 2000 and has since declined to nearer 10%. Public finances moved into surplus in 2000 after running an average deficit of 4% in the period 1995-1998. The rouble has appreciated in value against the dollar and the euro since the fall of 45% in its real effective exchange rate in 1998-99.

⁹ Military-industrial complex.

2.1. Public finances

The federal budget surplus grew to Rb 244.6 billion (US\$ 8.4 billion) in the first half of 2004. Analysts expect the full-year surplus to amount to 2.4% of GDP¹⁰, close to the 2003 result, but considerably greater than the official projection for 2004 of 0.5%, as the underlying oil price and economic growth assumptions have proved to be unduly conservative. For 2005, analysts expect the surplus to fall back to around 1%, provided oil prices decline as expected from current highs. The other major factor about which is some uncertainty is the government's expenditure reform programme, given the promise Mr Putin made in May 2004 to increase spending on infrastructure, healthcare, education and housing.

2.2. Economic growth

In its latest report¹¹, the World Bank notes that "Russia is continuing on a path of brisk economic growth...as growth rates in excess of 7% acquire an air of normality", although to set this in context the report also says that "seven out of eleven of Russia's CIS neighbours are growing at an even brisker pace". Official Russian estimates put annual real GDP growth at 7.2% for the first half of 2004. The energy sector remains the predominant factor in determining growth: there has been a strong link between world oil price levels and the growth of the Russian economy.¹² High fixed investment growth, rising consumer spending and a buoyant export sector have also contributed. Construction and retail sales were particularly buoyant. However, Russia's heavy dependence on energy exports means that any sustained decline in oil prices and further appreciation in the value of rouble could lead to a slowing of the real GDP growth rate in 2005, with analysts forecasting a rate of 5% to 5.5%.

There are a number of problems which make it difficult to assess accurately Russia's economic performance. One is the size of the shadow economy which it is believed may account for over 20% of activity especially in the small business sector. Another is the methodology used by the official statistical office Goskomsta in producing national accounts. This involves a number of indicators. One aspect of this, the long-standing controversy over transfer pricing - the sale by parent companies to subsidiaries of raw materials at arbitrary prices to reduce tax liabilities - was highlighted once again in a recent World Bank report on the Russian Federation.¹³

2.3 Wages and Prices

Following the disintegration of the Soviet Union, living standards fell sharply. Official figures suggest that by 1999, real household incomes were at only 40% of their 1991 level. However, such comparisons are problematic as they take no account of rationing or administered price levels under the old system. The situation is therefore probably not quite as bad as official data suggest. Real wages started to recover from 2000 onwards and rose by over 50% in the period 2001-03. Average nominal wages had

¹⁰ Economist Intelligence Unit (EIU), Country Report August 2004.

¹¹ Russian economic Report, June 2004

¹² The EIU has calculated the correlation at 0.8: i.e. a 10% change in oil prices leads to a 0.8% change in real GDP growth. For amore detailed analysis see the EIU Country Report, March 2004, p.32

¹³World Bank, Russian Economic Report, February 2004

risen by 28.5% year on year in April 2004 and by 17% in real terms. Minimum wage levels were increased by 33% in October 2003, which has helped to raise pay levels in traditional low-pay sectors such as health and education. Nevertheless, according to the trade unions, in 2003 more than 30 million people were still earning below the official monthly subsistence level of Rb 2 134 (US\$ 73.6). Income inequality has also increased sharply. The top 10% of the population in income terms account for around one-third of total income, the bottom 10% for less than 3% of the total.

Of course, continuing rises in real wages without corresponding productivity gains is raising labour costs and adding to inflationary pressures, but the strengthening rouble and the capping of utility price increases have helped to moderate the underlying inflationary pressures in recent months. The upper range of government's inflation target for end-2004 is 10%, but the signs are that this will be exceeded slightly. Money supply growth has been boosted by foreign-exchange inflows.

2.4 Employment

Unemployment in 2003 averaged 8.5%, up half a point on 2002. However, as in other areas, there are still some question marks over the collection and processing of labour market data. Goskomstat revised its data series in January 2004, bringing the recorded unemployment rate down to 8%. One problem is shadow incomes, particularly in the SME sector. The reform of taxes and, in particular, the reduction in the unified social tax on wage bills due to come into effect in 2005 should help to regularise the situation and draw more incomes into the official economy.

2.5 Monetary policy

The Russian Central Bank (RCB) has tended to give priority to **exchange rate policy** over reducing inflation. This approach runs counter to the advice of the IMF to target inflation; the aim is rather to support the diversification of the economy away from oil and gas and sustain GDP growth rates. The policy emphasis shifts periodically depending on whether overall government policy is focused more on boosting growth or raising living standards by curbing inflation. The Bank has limited instruments at its disposal. It hopes to keep the real effective appreciation of the rouble within 7% for 2004, but the sustained current-account surpluses are likely to make this difficult to achieve.

The recent crisis in the **banking sector** has been a cause for concern. One bank was forced into administration in May 2004, and another smaller bank filed for bankruptcy shortly afterwards. The RCB was criticised for its handling of the situation. On the orders of President Putin the RCB had to inject large sums of money into the market to increase liquidity, and the mandatory reserve rate was cut by 50%, easing the situation. However, the crisis shook public confidence and many private clients began to close accounts. In June 2004, Guta Bank collapsed and Alpha Bank, one of the largest private banks, also came under pressure but was ultimately saved from closure and taken over by Vneshtorgbank with funding from the Central Bank. A new law was passed obliging the RCB to guarantee bank deposits up to Rb. 100 000 in order to restore public confidence. Overall, the crisis has strengthened the influence of state financial institutions at the expense of the private sector. It has also highlighted the inability of the Russian financial sector to channel finance into the economy and help ensure it meets the growth targets.¹⁴

¹⁴ Oxford Analytica, Daily Brief, *Russia: midsummer crisis shows sector's fragility*, 23/07/2004
546218/EN

2.6 The external sector

Russia's total **foreign trade** grew rapidly in the period 1992-97. The collapse of the rouble in 1998 boosted exports further while reducing imports dramatically. Rising world energy and metal prices accentuated this trend in 1999-2000, producing a trade surplus of US\$ 60 billion in 2000. After the decline in 2001-2002, following the slowdown in the world economy, export earnings recovered strongly in 2003, and Russia continues to record high trade and current account surpluses despite the strong growth in imports. Revised data for 2003 provided by the Russian Central Bank show that the current account surplus amounted to US\$ 35.9 billion or 8.3% of GDP. In the first half of 2004, the current account surplus was US\$ 22.6 billion. Revenue from crude oil exports alone rose by 40%, boosting the rise in total exports to 22% in value terms. However, import expenditure grew by 24% as domestic demand surged. The current account is expected to continue to post surpluses, although analysts expect the surplus to decline as oil prices retreat from historic highs and large deficits on the services and income balances make themselves felt. The services deficit reached US\$ 11.1 billion in 2003, mainly as a result of foreign contractors being engaged on major capital projects. Higher levels of foreign borrowing by Russian corporations, the premium on credit to what is seen as a higher-risk country and the expected rise in US interest rates are likely to adversely affect the income account.

Russia's **export** performance is highly dependent on commodities, which makes it vulnerable to swings in world prices. Fuels represented 55% of Russia's visible exports in 2003, followed by metals, chemicals and timber. Machinery and equipment accounted for less than 10% of exports. Imports consist mainly of intermediate and finished goods with machinery and equipment accounting for 25% in 2003 and foodstuffs 15%. The EU is Russia's main trading partner with enlargement reinforcing this situation so that the EU now accounts for more than half of Russia's external trade. In 2003, only 15% of Russia's exports went to CIS countries, which accounted for 24% of its imports.

Inward **foreign direct investment** (FDI) to Russia totalled more than US\$ 1.1 billion in 2003, as measured by balance of payments data published by the Russian Central Bank. This is the lowest inflow since 1994. The net FDI figure was in deficit by US\$ 3 billion in the same period, as outward investment flows rose sharply.¹⁵ However, the data released by the RCB for the first quarter of 2004 indicates a sharp rise in inward FDI at US\$ 2.8 billion, although Goskomsat puts the amount at only US\$1.5 billion. A government report published in March 2004 claims that Russia could attract some US\$ 14 billion a year in FDI by 2007 and US\$ 20 billion by 2010.

Russia made further progress towards joining the **WTO** by concluding negotiations with the EU on 21 May 2004. Membership of the WTO is one of Vladimir Putin's priorities. It is expected that Russia will join the organisation by 2006-07. It would like to join sooner but bilateral agreements have still to be reached with other major trading partners. The direct trade effects of membership are expected to be limited as tariff levels are already low. Any negative effects will tend to affect sectors that are already performing poorly, while the potential benefits include increased foreign investment, a liberalised financial sector and an added impetus for further structural reforms.

¹⁵ Traditionally, there are marked differences between the FDI data released by the Russian Central Bank and the figures published by the statistical office, Goskomsat. In 2003, Goskomsat recorded FDI inflows of US\$ 6.8 billion. These are probably due to differences in methodology (Source: EIU, Country Report, June 2004)

2.7 Privatisation

Much of the privatisation of state assets took place in the 1990s. A group of well-connected entrepreneurs, the so-called 'oligarchs', were able to secure controlling interests in many of Russia's major companies at low prices.¹⁶ A recent World Bank study showed that the 23 largest business consortiums account for more than a third of the sales by Russian industry. Initially, the oligarchs tended to channel their assets abroad, but increasing political and economic stability and the improving business environment at home have provided a greater incentive to the oligarchs to re-invest more of their profits to maximise the value of their Russian investments.

In July 2003, the government headed by Mr Kasyanov announced an ambitious privatisation plan for 2004-08. The objective was for the state to have sold off its interests in all sectors except those that are considered of strategic importance or are exempted by law. This programme has been reaffirmed by the present government. In June 2004, there were still 9 222 state-owned companies and 3 905 incorporated companies in which the government had a stake. According to EBRD figures, the state sector produces about 30% of GDP. Opinion surveys indicate that a majority of the Russian public is hostile to further privatisation and would even like the boundaries between state and private sector to be moved back more in favour of public control. Despite recent signs of a trend towards greater state control of the economy, most noticeably in the handling of the Yukos affair and the banking crisis, the government still seems committed to liberal economic policies, at least up to the point where particular private interests have the power to influence what the political leadership see as its strategic decisions.¹⁷

The current privatisation programme has already suffered considerable delays as a result of the ongoing administrative reforms and lack of interest on the part of potential buyers worried by the Yukos affair. In addition, the list of strategically-vital companies was redefined by presidential decree on 4 August 2004 (about 3 000 companies are on the list, mostly in the military industrial field but also major utilities, airports, airlines, railways and national broadcasting media). In the first half of 2004, assets worth US\$ 139 million were sold, but the proposed sale of a 7.6% stake in Lukoil, due to be auctioned on 29 September, should boost the total. The target for both 2004 and 2005 is US\$ 1.38 billion.

3. Economic reforms

Although the government and the Duma are working together more closely than ever given that the President's party, United Russia, holds more than two-thirds of the seats, the scale of the government's agenda makes implementation - always a problem in Russia - an especially serious concern. The government is trying to press ahead with a wide range of reforms all at the same time, stretching its intellectual resources and administrative expertise to the limit. In the Duma sessions ending in July 2004 over one hundred bills were passed.

¹⁶ See also section II, 2.4. for more information on recent moves against the oligarchs

¹⁷ Oxford Analytica, Daily Brief, *Russia: Policies signal boundaries for private sector*, 13 August 2004

3.1 Fiscal reforms

Since 2000 a number of **tax changes** have been made. Personal income tax has been reduced to a flat-rate 13%. Social charges have been replaced by a single unified social tax (UST). Corporate tax has been reduced from 35% to 24% and has been simplified. Turnover taxes and the 5% regional sales tax have been abolished. VAT has been reduced from 20% to 18%. Taxes on the oil sector are set to be increased.

Reform of the **fiscal apparatus** has been a high government priority. The efficiency of data collection and dissemination has been improved at the same time as the management of public finances. Russia recognises the IMF code of best practice as the benchmark for fiscal transparency, although there are still some discrepancies in the methodology used by individual organisations. The key problem of fiscal reform in the Russian Federation has been administrative complexity and the relations between the federal, regional and local levels of government. Since 2001, the central government has pursued its policy of reforming inter-governmental relations. There is a consensus on the principle of achieving closer correspondence between the responsibilities of authorities and their fiscal base. Legislation passed in 2003 codified the fiscal responsibilities and rights of regional and municipal governments, and the budget and tax codes are being amended correspondingly. Financial transfers to the regions are increasingly based on objective indicators and an assessment of fiscal capacity. Ultimately, revenue from taxes with a mobile base, such as VAT, will be transferred completely to the federal authorities while personal and corporate taxes will go to the sub-national level. Few taxes are actually levied and administered locally and even those that exist tend to be collected by the federal tax authorities.

Budget reporting has also improved significantly. While off-budget activities have declined in importance, they still account for up to 50% of total resources in sectors such as education and health, and sub-national governments will still be able to set up their own off-budget funds. Control of public sector expenditure has improved dramatically since the reform of the federal treasury, although the situation is less clear at regional level. The main authority responsible for auditing government activities is the independent SP. It has free access to treasury data and can investigate discrepancies and make recommendations. It reports to parliament quarterly. However, it can only inspect the accounts of regional and local governments in so far as they use federal funds. Regional and local audit chambers exist, but there is no unified national standard.¹⁸

3.2 Land reform

On 21 June 2002, the Duma passed a bill allowing for the private ownership of land and a free market in commercial and urban land. An amendment was also adopted which prohibits foreigners from buying farmland; they may only lease for a maximum of 49 years.

3.3 Money Laundering

Russia was removed from the OECD blacklist of uncooperative countries in October 2002 after having adopted a raft of legislative texts. In June 2003, it became the 30th member of the Financial

¹⁸ Oxford Analytica, Daily Brief, *Russia: Reform improves control of public finance*, 12 July 2004

Action Group (GAFI) against money laundering and the financing of terrorism. To show it means business Russia has undertaken to monitor all transactions over US\$ 20 000 and all operations with offshore areas or notorious drug-producing countries.

3.4 Company law

The law governing joint-stock companies has been amended to improve the protection of minority shareholders' rights. While compliance with Russia's code of corporate governance is voluntary, publicly-listed companies must give details of their compliance. The bankruptcy code has been designed to protect companies from spurious bankruptcy proceedings, which were prevalent in the 1990s. Creditors must have tried and failed to recover debts before the courts will consider a bankruptcy petition.

3.5 Pensions and social welfare reforms

A small fully-funded pillar has been added to the existing Pay-as-you-go pension system. However, private pension funds still manage only a tiny fraction of the funds available.

In August 2004, the Russian Parliament passed a bill on **social benefits** under which the traditional Soviet-era allocation of benefits in kind to those eligible will be replaced by cash payments. In particular, free transport and free medical prescriptions for the elderly and disabled have been ended. Instead, non-indexed monthly payments of between Rb 800 and Rb 3 500 will be made. The government has argued that the benefits will be better targeted as a result of the change but as the subsidies are not paid directly to individuals but to intermediaries, it is feared that there will be considerable scope for corruption and embezzlement. There are also fears that inflation will erode the real value of the payments. The passage of the bill through the two houses of parliament was marked by demonstrations organised by trade unions and other groups over the summer months. In a move interpreted as a reaction to public protests, President Putin has recently signed a bill retaining the old-style benefits for civil servants and also promised that the military could keep many of their existing benefits.

III. RELATIONS BETWEEN THE EUROPEAN UNION AND RUSSIA¹⁹

1. Introduction

During the Cold War there was neither mutual recognition nor contractual relations between the European Community and the USSR. The Joint Declaration by the EEC and Comecon of June 1988 on mutual recognition between the two parties opened the way for the establishment of diplomatic relations. On this basis, the Community concluded a global agreement on trade and cooperation with the Soviet Union in December 1988. The goal was also to support the process of 'perestroika' initiated by President Gorbachov. The dissolution of the USSR in 1991 called for a complete review of this strategy. The EC was quick to appreciate properly the enormity of the changes in Russia and to play a role in supporting the reforms. Partnership and Cooperation Agreements were negotiated and signed with the new republics. The PCA with Russia was signed in 1994 and entered into force on 1 December 1997. The main focus is now on developing the four common spaces agreed in June 2003 and in launching the EU/Russia Permanent Partnership Councils which will bring together the EU Troika of Ministers and Russia on all matters of mutual interest.

In terms of bilateral relations between Russia and EU Member States, the most significant recent development has been the increasing cooperation between Russia, France and Germany. Summits of the three have become a regular fixture since 1998 and now take place twice a year. These have increasingly focused on international institutions such as the UN and the OSCE as well as on energy and the regional crises in Iraq, Afghanistan, Iran and the Caucasus. The three have said other countries might join the group provided they share its values and approaches to international law and security.

2. Cooperation and assistance

2.1. Partnership and Cooperation Agreement

This is a mixed agreement covering matters which fall both within the Community's remit and within the jurisdiction of its Member States, and which is initially to run for a period of 10 years. A suspension clause is provided, as in all the EU's agreements since 1992. A protocol to the agreement was signed by the EU and Russia on 27 April 2004 extending its provisions to cover the 10 new Member States. The provisions of the PCA include:

- measures aimed at liberalising trade: most-favoured-nation treatment and the abolition of quantitative restrictions;
- political dialogue: consolidated and increased dialogue at all levels on the basis of regular meetings between the institutions created by the PCA;
- economic and legislative cooperation: cooperation in sectors such as science and technology, energy, transport and the environment;
- justice and home affairs: cooperation to prevent illegal activities, cooperation to combat trafficking in drugs, money laundering and organised crime, as cooperation in these areas is still weak;

¹⁹ See annexes for trade data.

- institutions: summits, Cooperation Council at ministerial level, Cooperation Committee, Parliamentary Cooperation Committee and nine sub-committees on technical questions.

In parallel to the signature of the protocol to the PCA, a joint statement on EU enlargement and EU-Russia relations was also adopted. It acknowledges the opportunities between the EU and Russia for increased and intensified cooperation offered by EU enlargement and confirms the way that enlargement-related issues have been and will be addressed.

2.3. Political dialogue

The '**Common Strategy on Russia**' adopted by the Cologne European Council in June 1999 was the first of its kind since the creation of this instrument by the Treaty of Amsterdam. It was to remain in force until June 2004 and aimed to establish greater consistency in the EU's policies towards Russia. It combines the Member States' and EU policies and offers opportunities for cooperation with a view to establishing peace and stability in Europe. Whereas the PCA appears to attach greater importance to economic relations, the Strategy lays more stress on political action and security and concerns the following areas:

- consolidation of democracy, respect for the rule of law and public institutions;
- integration of Russia into a European Economic and Social Area;
- stability and security in Europe: particularly the management of crises and regional conflicts on Europe's doorstep (the Balkans, South Caucasus, Moldova);
- challenges common to the whole continent: environmental problems, organised crime, disarmament and the non-proliferation of arms, etc.

The Common Strategy did not provide new funding for Russia. The main instruments for implementing its goals remain the PCA, the Member States' assistance programmes and the Tacis programme.

Bi-annual **summits** between the EU and Russia provide opportunities for strengthening relations and determining the direction to be given to the PCA. Several summits have already taken place. The most recent, in May 2004, was held in Moscow and the next is scheduled for 11 November 2004 in The Hague. At the St. Petersburg summit, in May 2003 it was decided to strengthen the Cooperation Council by making it a Permanent Partnership Council (PPC). The first meeting of the PPC took place on 27 April 2004 and it is intended to hold meetings more frequently and in different ministerial formations. The EU and Russia also used the occasion of the Summit to launch a more strategic vision for relations, with the aim of creating a series of 'common spaces' - for external security; freedom, security and justice; economic cooperation; science and education, including culture - further exploiting the potential of the Partnership and Co-operation Agreement. Further discussions on these issues took place during the Moscow summit in May 2004.

As a reward for its reforms and to encourage it to continue along this path which will enable it to integrate more easily into the world economy, the EU has granted Russia market economy status. On 21 May 2004, an agreement was signed by the EU and Russia concluding bilateral negotiations for the accession of the Russian Federation to the WTO. However, Russia's relations with EU Member States have become increasingly strained and the aftermath of the Beslan tragedy is likely to intensify this development. In response to criticisms of human rights violations in Chechnya, Mr Putin has accused the West of double standards over terrorism.

2.4. Economic and food aid

Over the period 1996-1999, Russia benefited from financial assistance worth EUR 520.88 million from the EU-15 (including EUR 13.58 million in the form of debt cancellation), and from EUR 1577.50 million in EBRD credit. At the end of 1998, Russia was the recipient of a major food aid programme (worth EUR 470 million). It has also received humanitarian aid (via ECHO) for needy sections of its population.

2.5. Tacis technical aid

More than EUR 2.6 billion have been allocated to Russia under the Tacis programme since its start in 1991 with a view to promoting the transition to a market economy and to reinforcing democracy and the rule of law. The EU is the largest provider of economic and technical aid to Russia. Nearly all EU projects in Russia come under the Tacis technical assistance programme. In January 2000 the Council adopted a new Tacis Regulation covering the period 2000-2006. Tacis is increasingly being used to support the implementation of the PCA.

Russia also participates in the Tacis cross-border cooperation programme and in other multi-country initiatives covering areas such as the environment, energy and nuclear safety. From 2004 Russia is also eligible to benefit from the Tacis Neighbourhood Programme facility designed to support projects operating concurrently on both sides of the Russia/EU 25 border.

2.6. Trade²⁰

The Union is Russia's largest trading partner. Following enlargement, the EU's share of Russia's total external trade has risen from around one-third to more than half. Russia is now the EU's fifth trading partner (after the US, Switzerland, China and Japan). Total EU trade with Russia in 2003 amounted to € 85 billion, and the EU had a trade deficit of around € 20 billion.

- Main EU imports from Russia are energy (57%), agricultural products (4%) and chemicals (4%).
- Main EU exports are machinery (34%), chemicals (13%), agricultural products (11%), transport material (11%) and textiles (6%).

EU-Russia trade has more than doubled between 1995 and 2003: in 1995, EU trade with Russia amounted to € 38 billion (EU had a deficit of € 6 billion). However, Russia's manufacturing and trade structures continue to be unbalanced. In 2003, energy and fuels accounted for around 57 % of Russian exports to the EU, and EU-Russia trade in services is still rather limited in value terms: around €10 billion in 2002 in total, i.e. below 2 % of total EU trade in services.

EU imports from Russia are to a very large extent liberalised. Remaining EU restrictions, notably in the steel sector, are being addressed under a bilateral agreement. The current agreement foresees an overall increase of 40% of the mutually-agreed quotas and will expire at the end of 2004. The

²⁰ See Annexes

possibility of an agreement on trade in nuclear materials is foreseen in the PCA and negotiations will start in the near future.

Various macro-economic studies have concluded that the effects of EU enlargement will be positive for the Russian economy. For example, recent studies by the independent institute Brussels-based CEPS and the Moscow-based RECEP have estimated that Russian welfare will increase as a result of enlargement by just under 2%, with Russia's GDP, exports and its terms of trade improving concomitantly. Another major benefit for Russia has been the substantial reduction in tariffs of most of the new Member States. In short, for Russia, EU enlargement has simplified and enhanced access for Russian operators to the markets of the enlarged EU, notably of the ten new Member States.²¹

3. Other topical issues

On 9 February 2004, the European Commission adopted a Communication to the Council and the European Parliament on relations with Russia in response to a request from the European Council.²² The New Neighbours Initiative, launched by the EU in 2003 to provide a framework for enhanced cooperation with neighbouring countries for which there is no immediate prospect of EU membership, is clearly of major interest to Russia to the extent that it covers Belarus, Ukraine and Moldova, as well as the countries of the South Caucasus.

3.1. Kaliningrad

Kaliningrad has remained high on the agenda of EU-Russia relations. The Joint Statement on Kaliningrad adopted by the EU-Russia Summit of 11 November 2002 addressed the issue of transit of people and goods between Kaliningrad and the rest of the Russian Federation. The two sides expressed their intention to respect the interests of Lithuania and to foster economic and social development in the region. At the St Petersburg summit on 31 May 2003, the EU representatives accepted the principle of the eventual abolition of visas between the EU and Russia. A specific transit regime for travellers between the enclave and Russia, based on facilitated travel documents, came into effect in July 2003. Lithuania is to receive EUR 12 million (from the PHARE programme) to implement the agreement. Issues related to transit of goods were also addressed in the April 2004 Joint Statement on EU enlargement and EU-Russia relations. Further, the EU has put forward substantial financial assistance to support the socio-economic development of the Kaliningrad oblast. Between 1991 and 2003, the EU has committed over € 50 million of technical assistance to the region. Another € 50 million have been earmarked for the period 2004-2006, under a special programme for Kaliningrad, the new Neighbourhood Programme and for improving border crossings. A feasibility study on non-stop high-speed trains is currently being carried out.

Although passenger traffic is no longer a problem, Russia has criticised the situation with regard to goods traffic between Russia and its Kaliningrad enclave via Lithuania. President Putin's Special Envoy for EU-Russia relations, Sergey Yastrzhembskiy, told MEPs on 22 September 2004 that instead of three hours, customs procedures now lasted 3 to 4 days, and that customs tariffs had risen 30-50%. He also referred to concerns about the position of Russian-speakers - and many "stateless persons" - in Latvia and Estonia, as another "topical issue" in EU-Russia relations. He indicated

²¹ Source: European Commission, DG Trade website.

²² COM(2004) 106

that a border agreement between Russia and Latvia could only be signed “against a background of a general improvement in Russia-Latvia relations”.

3.2 Meat exports

On 2 September 2004, the EU and Russia settled a dispute on livestock and meat exports. Russia had banned all EU animal-based food imports for three days in early June when it suddenly refused to accept the current system of veterinary certificates. Food from major EU trade partners in both new and old Member States was held up at the border until Russia agreed to extend the current arrangements until the end of September. This means EU exports of livestock and animal products to Russia can continue from October 1. The EU has agreed to use uniform veterinary certificates to testify that food is safe - as Russia originally requested - but these will be signed by each exporting country. The EU had resisted Moscow's call for one single certificate signed by a central authority, saying the European Commission could not sign for all the Member States. The new certificates will be introduced on October 1 and the old ones will be phased out by the end of the year.²³

3.3 Kyoto Protocol

On 30 September 2004, the Russian government agreed to adopt a climate-change treaty bill which will be sent to the Duma for approval. Mr Putin had already expressed support for the treaty despite opposition from some senior government figures worried about the impact on economic growth. Ratification of the treaty will allow it to come into force despite US opposition.

²³ EIS, Daily Report, 3 September 2004

Historical Background

In the 7th and 8th centuries, the current territories of Ukraine and Belarus were primarily populated by Slavic tribes, of Indo-European origin. In the 9th century, various political and cultural forces united, leading to the formation of what is known as Kievan Rus'. This state (later called the 'first' Russian empire) fell victim to the Mongol invasions of the 12th century. The Slav centre of gravity then shifted towards Muscovy in the North-East.

In 1490, the Muscovite prince Ivan III put an end to two and a half centuries of Mongol domination. Russian expansion could then begin²⁴. François Thuau summarised this expansion as follows: 'Over 300 years, the Russian Empire was formed by advancing the equivalent of 140km² daily.' Towards the mid-nineteenth century, the Russian Empire extended over three continents: Europe (eastern), Asia (all of the northern part and the newly-conquered Turkestan) and America (Alaska, later sold to the Americans). However, the Russian Empire revealed itself to be a giant with clay feet: tsarism was incapable of adapting its political system to the economic and social development of nineteenth century Russia. The First World War and the October Revolution of 1917 facilitated the fall of the Empire and its replacement by the USSR (1922).

In turn, the Soviet regime, shaken by the war in Afghanistan and by the rise of regional nationalism (the Baltic Republics and Caucasus), and incapable of facing up to the new technological challenges of the late twentieth century, went into its death throes. The attempted neo-communist putsch of August 1991 hastened the end of the USSR. On 29 December 1991, the Russian flag replaced the Soviet flag on the Kremlin, giving birth to 15 independent states on the ruins of an empire stretching over 'a sixth of the earth's land mass'. Having returned to their seventeenth century borders, '....the Russians' hope is for a civilised Russia to finally and conclusively join the great Western nations.'²⁵

With an area of 17 075 400 km², Russia is still the largest country in the world, forming a sort of amphitheatre opening onto the Arctic Ocean, bordered by mountains in the south and the east. It has borders with numerous European and Asian countries: Norway, Finland, Estonia, Latvia, Lithuania, Poland, Belarus, Ukraine, Georgia, Azerbaijan, Kazakhstan, Mongolia, China and North Korea²⁶.

With a mortality rate which continues to rise (14.7 per 1000) and a birth rate which continues to fall (8.4 per 1000), Russia has, since the 1990s, experienced a marked decrease in its population – from 147.8 million in 1989 to 145 million in 2001. 81.5% of the population are Russians, with 3.8% Tatars (or Tartars) and 3% Ukrainians.

²⁴ See Annex 2.

²⁵ Hélène Carrère d'Encausse, *La Russie inachevée*, Fayard, Paris, 2000.

²⁶ See Annex 1.

Russian Federation

Head of State

Vladimir PUTIN (elected March 2004 for a second term)

Composition of the Federal Government

Prime Minister	Mikhail FRADKOV
Deputy Prime Minister	Aleksandr ZHUKOV
Government Chief of Staff	Dimitry KOZAK
Agriculture	Aleksei GORDEYEV
Civil Defence & Emergencies	Sergei SHOIGU
Culture & Mass Communications	Aleksandr SOLOKOV
Defence	Sergei IVANOV
Economic Development & Trade	German GREF
Education & Science	Andrei FURSENKO
Finance	Aleksei KUDRIN
Foreign Affairs	Sergei LAVROV
Health & Social Development	Mikhail ZURABOV
Industry & Energy	Viktor KHRISTENKO
Internal Affairs	Rashid NURGALIYEV
Justice	Yuri CHAIKA
Natural Resources	Yuri TRUTNEV
Telecommunications	Leonid REIMAN
Transport	Igor LEVITIN
Central Bank Governor	Sergei IGNATIEV

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DOCUMENT SECTIONS

Economic structure: Annual indicators

	1999 ^a	2000 ^a	2001 ^a	2002 ^a	2003 ^a
GDP at market prices (Rb bn) ^b	4,823	7,306	8,944	10,834	13,285
GDP (US\$ bn)	195.9	259.7	306.6	345.6	432.9
Real GDP growth (%)	6.2	10.5	5.1	4.7	7.3
Consumer price inflation (av; %)	85.7	20.8	21.5	15.8	13.7
Population (m)	146.3	146.2	145.8	145.3	144.7
Exports of goods fob (US\$ m)	75,549	105,034	101,885	107,302	135,929
Imports of goods fob (US\$ m)	-39,537	-44,862	-53,763	-60,965	-75,436
Current-account balance (US\$ m)	24,611	46,840	33,795	29,116	35,845
Foreign-exchange reserves excl gold (US\$ m)	8,457	24,264	32,542	44,054	73,175
Total external debt (US\$ bn)	174.8	160.0	152.5	147.5	167.6 ^c
Debt-service ratio, paid (%)	13.6	9.9	14.3	11.2	10.0 ^c
Exchange rate (av) Rb:US\$	24.62	28.13	29.17	31.35	30.69

^a Actual. ^b Includes statistical discrepancy. ^c Economist Intelligence Unit estimates.

Origins of gross domestic product 2003	% of total	Components of gross domestic product 2003 ^a	% of total
Agriculture	5.2	Private consumption	50.6
Industry	35.2	Public consumption	16.9
Services	59.6	Fixed investment	18.2
		Stockbuilding	2.4
		Net exports of goods & services	11.4

Principal exports 2003	% of total	Principal imports 2003	% of total
Oil, fuel & gas	51.6	Machinery & transport equipment	25.8
Metals	12.8	Food, beverages & agricultural products	14.8
Machinery & transport equipment	7.9	Chemicals	12.1
Chemicals	6.2	Metals	4.8

Main destinations of exports 2003	% of total	Main origins of imports 2003	% of total
Germany	8.2	Germany	12.9
Italy	6.1	Belarus	6.4
Netherlands	5.8	Ukraine	5.9
Italy	6.1	China	4.1
China	6.2	Kazakhstan	3.9
Ukraine	5.6	US	3.9

^a Includes statistical discrepancy between the production side and the expenditure side.

Basic statistics for Belarus, Russia and Ukraine

	<u>Belarus</u>	<u>Russia</u>	<u>Ukraine</u>	<u>European Union (15)</u>
Area (1000 sq. km)	208	17.202	604	3191
Population (Mio, 1 January 2001/02)	10,0	144,0	49,0	377,7
Population/sq.km	48	8	81	118
Infant mortality (per 1000, in 2001/02):	7,8	14,6	11,4	4,5
Expectation of life at birth, 2001/02: Females	74,1	71,9	74,0	81,6
Males	62,3	58,5	63,0	75,5
Demographic dependency 2001 (1):	46,6	42,9	45,8	49,6
Gross domestic product (2002), in MIO USD:	14.304	346.520	41.380	8.666.590
MIO EUR:	15.121	366.300	43.742	9.161.300
Gross national income/capita in PPP; EU=100 (2001)	31,0	28,9	17,7	100,0
Real growth of GDP, 2003 (provisional)	6,8	7,3	9,3	0,8
Real growth of GDP, 2004 (forecasts)	4,8	6,0	6,0	2,0
Real growth of GDP, 2005 (forecasts)	3,5	5,3	4,0	2,4
Structure of economy (% of GDP) 2000: Agriculture	15,3	7,1	13,8	2,1
Services	47,3	54,2	47,7	69,6
Net official development assistance (2000, % of GDP)	0,1	0,6	1,7	-0,4
External indicators:				
Exports as % of GDP (2002):	56,6	30,9	43,4	10,8
Balance of payment (2003, MIO EUR):				
Balance on goods and services:	-599	43.679	1.139	67.491
Current account:	-447	31.746	2.556	53.628
Current account (% of GDP)(2002):	-2,6	9,0	7,7	0,5
Direct investment (in reporting economy)	151	1.011	1.259	-46.770 (2)
Total external debt (2002, MIO EUR):	959	155.963	14.329	
Debt service as % of exports of goods and services:	2,1	11,3	13,7	
Labour force (%):				
Agriculture	20	14	20	5,3
Female : % of labour force 1995	49	49	49	42
Adult literacy rate (%), 1998	99,5	99,5	99,6	98,4
Consumer Prices (%): 2003	28,4	13,7	5,2	1,8
Consumer Prices (%): 2004	22,7	11,2	6,9	1,8
Consumer Prices (%): 2005	13,6	9,9	4,6	1,7
Gini index (latest year available)(3)	21,7	48,7	29,0	(4)
Enviromental: Carbon Dioxide tonnes/capita: 2000	5,55	10,34	6,08	8,38
Internet hosts/10000 inhabitants (2002)	4,06	27,92	14,30	404,57(5)
2003 Transparency: Corruption Perceptions Index	4,2	2,7	2,3	4,3-9,7(6)
TV/1000 inhabitants, 1999	322	421	413	574
Telephones: main lines/1000 inhabitants, 1995	190	170	157	462
Human development index (2002) (7):	0,790	0,795	0,777	0,930

Sources: EUROSTAT, IMF, OECD, UN, ITU and World Bank

Production: JDa/DG4/European Parliament (31/08/2004)

(1) Population under 15 and over 64 as % of population between 15 and 65; (2) net

(3) A lower figure indicates a more even income distribution (0 represents perfect equality)

(4) Varies between 23,1 (Austria) and 36,1 (UK); (5) Weighted average; from 119,13 in Italy to 2343,12 in Finland; (6) Greece 4,3/Finland 9,7

(7) Based on three indicators: 1) longevity, 2) educational attainment and 3) standard of living measured by GDP per capita in PPP (for details see Human Development Report, UNDP)

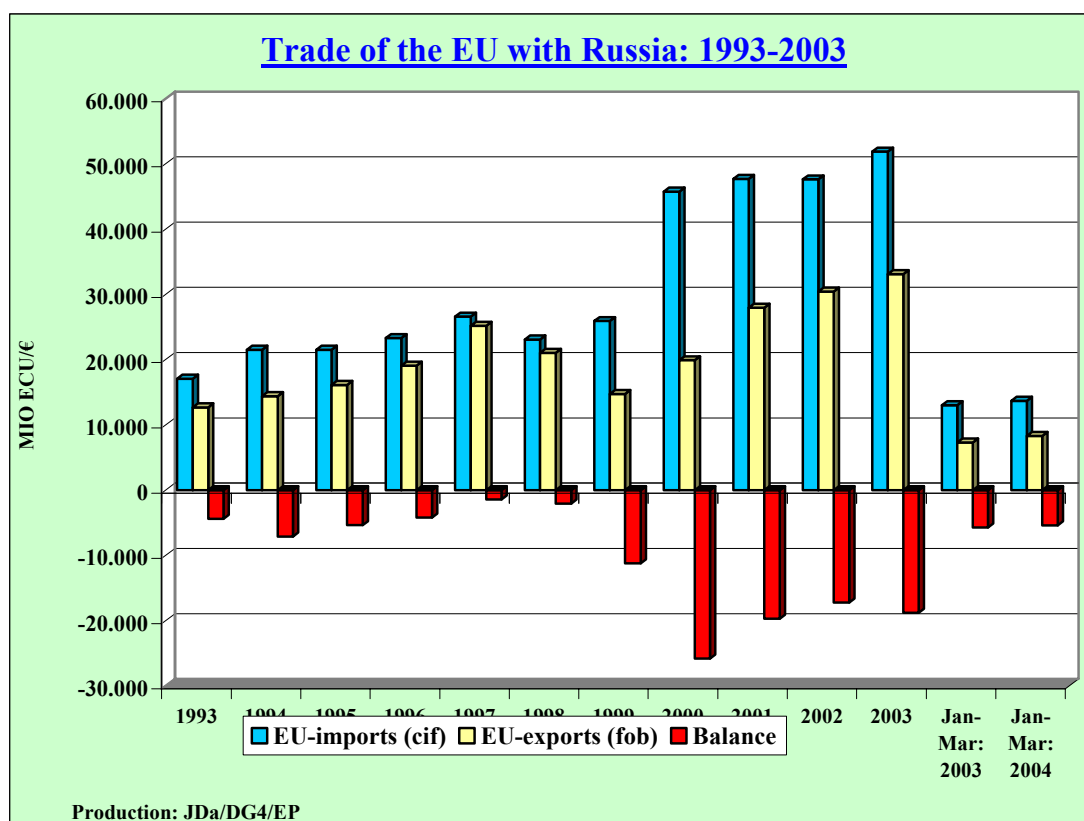
Conversion rate: 2001: 1 EUR=0.896 USD; 2002: 1 EUR=0.946 USD; 2003: 1 EUR=1.131 USD

Trade of the EU with Russia: 1993-2003

	<i>MIO ECU/€</i>		
	EU-imports (cif)	EU-exports (fob)	Balance
1993	17.089	12.699	-4.390
1994	21.498	14.385	-7.113
1995	21.491	16.128	-5.363
1996	23.298	19.093	-4.205
1997	26.591	25.179	-1.412
1998	23.090	21.046	-2.044
1999	25.926	14.727	-11.192
2000	45.724	19.917	-25.785
2001	47.688	27.961	-19.708
2002	47.624	30.424	-17.199
2003	51.873	33.085	-18.788
Jan-Mar: 2003	13.024	7.293	-5.731
Jan-Mar: 2004	13.685	8.299	-5.386

Source: COMEXT database, EUROSTAT

Production: JDa/DG4/European Parliament



Trade of the EU with Russia by Member States

EU-imports (cif)

1000 €

	2003		January-March:		
	1000 €	- % -	2003	2004*	% changes
Total	51.872.539	100,0	13.024.031	13.684.789	5,1
<i>of which:</i>					
France	5.948.942	11,2	1.493.319	1.686.706	13,0
Netherlands	5.321.975	10,2	1.066.806	1.663.399	55,9
Germany	13.154.472	25,4	3.104.531	3.090.107	-0,5
Italy	8.248.214	16,0	2.275.583	2.258.967	-0,7
United Kingdom	3.702.521	7,2	840.396	1.030.660	22,6
Ireland	41.698	0,1	12.983	22.963	76,9
Denmark	500.787	0,9	127.751	139.644	9,3
Greece**	2.376.710	4,7	410.744	327.220	-20,3
Portugal	519.079	1,0	159.123	112.559	-29,3
Spain	2.843.926	5,5	761.615	614.965	-19,3
Belgium	2.266.319	4,4	580.656	647.162	11,5
Luxembourg	13.362	0,0	1.513	3.258	115,4
Sweden	1.326.993	2,6	390.101	406.450	4,2
Finland	4.359.821	8,5	1.200.215	1.214.388	1,2
Austria	1.247.718	2,4	346.178	302.732	-12,6

EU-exports (fob)

Total	33.084.877	100,0	7.293.287	8.298.618	13,8
<i>of which:</i>					
France	2.811.628	8,4	684.747	701.802	2,5
Netherlands	2.920.829	8,9	700.689	737.361	5,2
Germany	12.109.020	36,8	2.548.494	3.294.667	29,3
Italy	3.847.395	11,7	839.415	915.866	9,1
United Kingdom	1.960.441	6,0	415.336	416.588	0,3
Ireland	251.397	0,8	53.984	47.146	-12,7
Denmark	750.188	2,3	165.693	181.075	9,3
Greece**	296.895	0,8	31.417	27.533	-12,4
Portugal	39.616	0,1	7.994	8.554	7,0
Spain	809.108	2,4	197.855	195.820	-1,0
Belgium	1.299.493	3,9	309.424	312.229	0,9
Luxembourg	39.964	0,1	8.356	12.021	43,9
Sweden	1.212.309	3,6	274.696	297.631	8,3
Finland	3.494.195	10,5	767.951	857.496	11,7
Austria	1.242.397	3,8	269.409	279.063	3,6

Source: COMEXT database, EUROSTAT

Production: JDa/DG4/European Parliament

* including estimation for Greece for March

**Greece: January-February of 2003 and 2004

Trade relations EU-Russia: 2003

Structural analyses

EU-imports (cif)

	1000 €	- % -	<u>Main products (SITC division):</u>	SITC 3rd rev.	1000 €	% of total	Intra-industry trade intensity (1)
Total	51.872.539	100,0	PETROLEUM, PETROLEUM PRODUCTS AND RELATED MATERIALS	33	26.470.828	51,0	198,9
<u>of which:</u>			NON-FERROUS METALS	68	3.324.304	6,4	185,7
A: Raw materials	32.514.176	62,7	GAS, NATURAL AND MANUFACTURED	34	2.091.984	4,0	199,9
Food, beverages and tobacco (0+1)	652.805	1,3	IRON AND STEEL	67	1.686.731	3,3	164,8
Raw materials (2+4)	2.268.285	4,4	CORK AND WOOD	24	1.180.798	2,3	197,3
Energy (3)	29.593.086	57,0	NON-METALLIC MINERAL MANUFACTURES, N.E.S.	66	1.069.089	2,1	129,8
B: Manufactured articles	9.966.034	19,2	INORGANIC CHEMICALS	52	900.113	1,7	181,8
Chemicals (5)	2.124.976	4,1	COAL, COKE AND BRIQUETTES	32	758.816	1,5	199,5
Machinery and transport eq. (7)	544.461	1,0	METALLIFEROUS ORES AND METAL SCRAP	28	739.562	1,4	188,6
Other manufactured products (6+8)	7.296.597	14,1	ORGANIC CHEMICALS	51	633.869	1,2	148,5

EU-exports (fob)

	1000 €	- % -	<u>Main products (SITC division):</u>	SITC 3rd rev.	1000 €	% of total	Intra-industry trade intensity (1)
Total	33.084.877	100,0	ROAD VEHICLES (INCLUDING AIR-CUSHION VEHICLES)	78	2.924.089	8,8	4,7
<u>of which:</u>			GENERAL INDUSTR. MACH. + EQUIPMENT, N.E.S., MACHINE PARTS, N.E.S.	74	2.461.299	7,4	3,1
A: Raw materials	3.765.101	11,4	MACHINERY SPECIALIZED FOR PARTICULAR INDUSTRIES	72	2.329.145	7,0	6,6
Food, beverages and tobacco (0+1)	2.933.320	8,9	TELECOMMUNIC. + SOUND RECORDING + REPROD. APPARATUS + EQUIPMENT	76	2.294.986	6,9	2,0
Raw materials (2+4)	683.751	2,1	ELECTR. MACH., APP. + APPLIANCES, N.E.S. + ELECTR. PARTS THEREOF	77	2.109.031	6,4	7,6
Energy (3)	148.030	0,4	OFFICE MACHINES AND AUTOMATIC DATA-PROCESSING MACHINES	75	1.721.777	5,2	1,5
B: Manufactured articles	28.691.676	86,7	ARTICLES OF APPAREL AND CLOTHING ACCESSORIES	84	1.230.203	3,7	14,7
Chemicals (5)	4.416.403	13,3	MISCELLANEOUS MANUFACTURED ARTICLES, N.E.S.	89	1.223.732	3,7	16,6
Machinery and transport eq. (7)	15.424.562	46,6	MEDICAL AND PHARMACEUTICAL PRODUCTS	54	1.014.548	3,1	0,4
Other manufactured products (6+8)	8.850.712	26,8	PAPER, PAPERBOARD + ART. OF PAPER PULP, OF PAPER OR OF PAPERBOARD	64	936.005	2,8	47,7

Source: COMEXT 2 database, EUROSTAT

Production: JDa/DG4/European Parliament

(1) The index can vary between 0 and 200: 0 means only exports, 200 only imports and 100 means balance in trade

Index: $\frac{((x+m)-(x-m))}{(x+m)} * 100$

External trade of Russia: 1996-2002

Mio ECU/€

	Export					Import				
	Total	of which:				Total	of which:			
		EU-15		EU-25			EU-15		EU-25	
		Mio ECU	%	Mio ECU	%		Mio ECU	%	Mio ECU	%
1996	69.859	20.023	28,7	28.319	40,5	47.736	12.392	26,0	15.040	31,5
1997	75.737	24.874	32,8	35.412	46,8	58.487	17.280	29,5	21.324	36,5
1998	66.150	20.820	31,5	29.612	44,8	52.624	14.086	26,8	17.081	32,5
1999	70.055	23.316	33,3	32.756	46,8	37.934	10.490	27,7	12.179	32,1
2000	111.527	39.936	35,8	58.954	52,9	49.212	12.061	24,5	14.369	29,2
2001	110.757	37.174	33,6	54.542	49,2	46.367	17.063	36,8	20.066	43,3
2002	106.119	36.716	34,6	52.706	49,7	44.517	19.312	43,4	22.864	51,4

Source: COMTRADE, UN/ EUROSTAT

Production: JDa/DG4/European Parliament

Note: **Bold**, *italic* and underlined text/figures indicate updated and/or revised data