



EU-Russia trade relations State of play and prospects

SUMMARY *EU-Russia trade relations are growing again, after a drop in 2009. Russia is the EU's main energy supplier. In return, the EU provides Russia with high-tech, manufactured products.*

Despite widespread fears of European dependence on Russian energy supplies, the overall picture is more complex. It is true that Russia has a strong comparative advantage in fuel, but is quite weak as an exporter of manufactured goods. Therefore it is heavily dependent on its income from energy exports. The infrastructure in place, and long-term contracts which are difficult to vary, also make Russia dependent on its European clients.

The long-awaited accession of Russia to the World Trade Organisation raises hope of progress towards a new EU-Russia agreement. The remaining challenges concern in particular the implications of EU energy policy for Russia, the EU visa regime for Russian citizens, and Russian (ab)use of sanitary measures in import restrictions for food products from the EU. However, a number of bilateral trade-related problems were resolved in the agreements that paved the way for EU approval of Russia's WTO accession.



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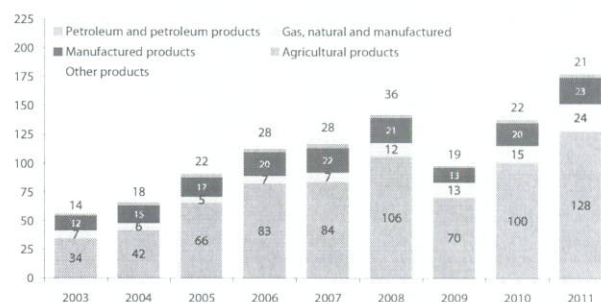
Main trends in EU-Russia trade

Strong and growing relationship

Trade relations between Russia and the EU are of key and growing importance for both sides. The EU is Russia's first trade partner, accounting for 47% of its overall trade by value in 2010. It is estimated that up to 75% of foreign direct investment (FDI) stocks in Russia come from the EU. For the EU, Russia is the third largest trade partner, with a 9.5% share of overall trade.

Energy, mainly petrol and gas, accounts for 76% of EU imports from Russia, which is the EU's largest foreign energy supplier with 33% of total fuel imports (2011).

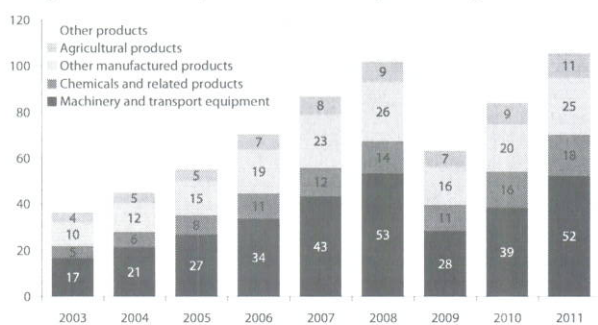
Figure 1 - EU imports from Russia (€ billion)



Data source: Eurostat

Some 86% of EU exports to Russia are manufactured goods, in particular machinery and transport equipment. Agricultural products account for a further 10% of EU exports to Russia.

Figure 2 - EU exports to Russia (€ billion)



Data source: Eurostat

After the sharp drop recorded in 2009, due to the economic crisis and unilateral Russian measures, bilateral trade has returned to rapid growth. In the first nine months of 2011 trade in goods with Russia was up 27%.

Features of Russian trade vs. EU

Russia is a world leader in oil and gas production, producing around 18% of world gas and 12% of crude oil.¹

One of the most significant elements of Russia's foreign trade structure is a **high dependency on hydrocarbon export**. Indeed exports of fuel, gas and related products accounts for 64% of total Russian export revenue (2010). This leaves its external trade balance vulnerable to highly unpredictable changes in world energy markets. Some point as well to the risk of "Dutch disease": increased revenues from natural resources causes a rise in the value of the national currency, and thus a decline in the competitiveness of the domestic manufacturing sector.

The EU is a major buyer of Russian energy: 54% of its fuel and gas exports go to the EU. Manufactured goods represent 19% of total Russian exports, and slightly less than 13% of Russian exports to the EU (2010). In parallel Russian imports of manufactured goods are growing strongly, increasing the negative trade balance in manufactured goods with its main partners such as the EU and China. The opposite trend can however be seen in its trade relations with the CIS (Commonwealth of Independent States).²

The Russian Federation seeks to reduce its economic dependence on the energy sector with the goal of reducing energy exports to 20% of GDP by 2030.³ As researchers point out, resource-rich countries find it particularly hard to shift their export structure away from commodities and into manufacturing. Indeed Russia has strong comparative advantage in fuel, the mining sector and raw materials, but much less in manufactured goods.

In trade with the EU it has been estimated that Russia is competitive in five categories of manufactured products⁴:

- Fertilisers
- Inorganic and organic chemicals
- Iron and steel
- Leather and leather goods
- Non-metallic mineral products.

Contrary to Russia, the EU, and especially the euro area, has comparative advantage in capital and research-intensive products, as well as in labour-intensive goods and medium-high-tech products.⁵ And there is convergence in export specialisation patterns between old and new EU Member States.⁶

Comparative advantage

"The advantage enjoyed by a country in the cost ratio of one commodity to another, in comparison with the ratio of costs of these same commodities elsewhere. According to the principle of comparative advantage, gains from trade follow from allowing an economy to specialise. ... A country does not have to be best at anything to gain from trade. The gains follow from specialising in those activities which, at world prices, the country is relatively better at, even though it may not have an absolute advantage in them. Because it is relative advantage that matters, it is meaningless to say a country has a comparative advantage in nothing. The term is one of the most misunderstood ideas in economics, and is often wrongly assumed to mean an absolute advantage compared with other countries." (source: WTO, after Paul Samuelson)

Policy framework

Partnership and Cooperation Agreement (PCA)

In force since 1997, for an initial period of ten years and extended annually from 2007, the PCA is a key legally binding agreement fostering bilateral political, cultural and economical relations. One of its objectives is the promotion of trade and investment.

Cooperation and regulatory dialogue have been developed since 2003 in four "common spaces": the economic space, the common space of freedom, security and justice, the common space of external security, and the common space of research, education and culture. Dialogue in the framework of the economic space includes trade issues, such as elimination of trade barriers, regulatory convergence and market opening.

The PCA's ultimate objective is an integrated market between the EU and Russia. Every year the Commission (now the External Action Service) issues a report detailing the progress made in each field. The 2010 report concludes that there was limited progress in trade-related areas, mostly in the dialogue on intellectual propriety rights.

Partnership for Modernisation (2010)

Signed at the EU-Russia summit in June 2010, this new initiative aimed to enhance cooperation in the four "common spaces" including the common economic space. Commentators in general agree that EU-Russia relations have not progressed much as a result of this agreement, except in the field of education and scientific cooperation.⁷ There are also bilateral modernisation memorandums between most EU Member States and Russia, setting out specific projects in joint work programmes.

New EU-Russia Agreement

Negotiations on a new EU-Russia agreement, which started in June 2008, have seen limited progress in recent years. Trade

issues are the main point of contention. The main aim was that the EU would offer Russia a free trade agreement (FTA) and Russia would sign binding rules on energy trade, transit and investment in return. One blockage was the prolonged negotiations on WTO accession, seen as a necessary prerequisite for an FTA. Paradoxically once this issue was resolved, Russian officials started to use the fact of WTO accession to as an argument against any additional trade concession towards the EU going beyond the new Russian WTO commitments.⁸

Numerous EP resolutions on EU-Russia relations touch upon trade-related issues. Recently, in a resolution of 14 December 2011, Members called for greater efforts to be made to progress the EU-Russia Partnership for Modernisation, which they say has the potential to develop mutually beneficial trade, economic and energy security cooperation. The EP welcomed the completion of negotiations on Russia's accession to the WTO and stressed that Russia had a legal obligation to fulfil all WTO rules including to renounce protectionist measures. The EP's INTA committee has been preparing reports, under the consent procedure, on a number of specific bilateral agreements linked to Russia's WTO accession: Ongoing procedures cover issues such as trade in wood, car parts, raw materials, steel and services. Separately, the AFET committee is preparing an EP recommendation to the Council and the Commission on a new EU-Russia Agreement.

Russia's accession to the WTO

Long route to the WTO

After 18 years of negotiations, in December 2011, agreement was reached on the conditions of Russian accession to the WTO. Its membership will become effective 30 days after ratification by the Russian parliament, which has to take place by 15 June 2012.

Parallel to multilateral talks on general issues, there were 62 bilateral negotiations with states involved in commercial relations with Russia. Some of the parties, such as Georgia, which have difficult relations with Russia, were felt to be slowing down the process. Moreover, Russia's commitment to the talks was fluctuating, making some observers doubt its willingness to join the WTO. Indeed deep controversy emerged in Russia's political and economic spheres regarding the potential impact of WTO membership.

Internal controversy about WTO membership

Most commentators agree that in the long term, the opening of the Russian economy is a necessary step towards modernisation of its industry, most notably through technological flows and the impact of foreign investment. Still the need to diversify has been seen as less urgent since the 2008 rise in commodity prices.

On the other hand, in the short term, opening up the Russian economy is expected to be painful. Lowering tariffs following WTO accession will profit a few industries, in particular the metals and chemicals industries, but would reduce the competitiveness of a majority of Russia's manufacturing, leading to a rise in unemployment.⁹ This could have a particularly dramatic effect on Russia's "monotowns" - cities that depend entirely on a single industry or factory.

From this perspective, the main short-term advantage of WTO accession for Russia is of a political nature: increasing its influence in world governance.¹⁰ Indeed Russia was the only permanent member of the UN Security Council, the G8 and G20 not to have a say in WTO decision-making.

Bilateral EU-Russia agreements

From an external perspective, one of the major advantages of Russia's WTO accession, besides general tariff reductions, is increased predictability and legal security.

The EU will now have more means of recourse if Russia takes unilateral action disrupting trade, such as introducing quotas, bans, prior authorisation or licensing requirements, not allowed under WTO rules.

Additionally, a number of bilateral agreements have paved the way towards EU approval of Russia's accession, clearing up a number of long-standing difficult bilateral issues. Of these, the last remaining issues were resolved only in 2011. Among the most important were:

Siberian overflight fees

In 2011, an agreement was reached on the abolition, from 1 January 2014, of fees that European airlines have to pay for trans-Siberian flights. Accordingly to IATA the average Siberian over-flight fees, varying from one bilateral agreement to other and often secret, are around US\$3 500 per flight. The EU expects that from now on, any payments to fly over Siberia will be cost-based and non-discriminatory.

Domestic price for industrial users of gas

Russia has a pricing system for natural gas which can have a discriminatory effect on the competitiveness of EU industry. In April 2012, the price of Russian gas varied from between \$75 and \$97 for domestic markets (with private consumers paying less and industry more), around \$250 for former Soviet states, and \$350 to \$450 per 1000 m³ (tcm) for EU customers.

In April 2012, Gazprom put forward a series of measures to drastically raise the price for natural gas on the domestic market for industrial users: up 26% by the end of 2012, 45% by the end of 2013 and full liberalisation by 2014. This is likely to have a significant negative impact on the competitiveness of Russia's metal industry.¹¹

Export duties for raw timber

The rise in Russian export duties since 2007 has caused concern on the EU side. Russia aimed to force foreign companies to move at least some of their wood-processing capacity onto its soil. But the issue became

less pressing with the signature in December 2011 of the bilateral wood agreement for Russia's WTO accession. The EU obtained reliable tariff reductions for quotas of timber exports, which the European Commission will distribute amongst the importers of Russian wood.¹²

Investment regime for car production

In 2010, Russia offered some incentives to carmakers to increase their production in Russia if they use local parts and open research centres. Those measures were incompatible with the WTO Trade-related Investment Measures (TRIMs) agreement. Despite pressure from the EU and US, Russia decided to keep those measures until at least 2018. However if the export of EU car parts to Russia drops as a result of the new investment regime, an agreed compensation mechanism may be triggered.

Customs union with Kazakhstan and Belarus and its compatibility with WTO rules

The customs union with Belarus and Kazakhstan, which are not WTO members, may affect the implementation of Russian accession. Commentators note that the EU is not ready to extend automatically the concessions offered to Russia to other countries, especially as trade deals are used as a carrot in [the European Neighbourhood Policy](#).

Key future challenges

From the EU perspective, there are still a number of potential challenges in bilateral trade relations:

Import bans on agricultural products as tools to pursue political goals

The EU is critical of the frequent use of sanitary reasons to introduce restriction on the import of food and livestock from the EU. The most recent ban on imports of live animals dates from March 2012. According to the European Commission, the ban is unjustified from a scientific perspective and not in line with WTO rules.¹³ The Russian ban on Polish beef supplies in 2006-08 led to an

18-month-long suspension of negotiations on a new EU-Russia agreement.

European dependency on Russian energy

The [reliance on Russian energy supplies](#) varies highly among Member States.

For gas for example, some countries (Denmark, Ireland, Portugal, Spain, Sweden and the UK) import no Russian gas at all while others (Bulgaria, Romania and the Baltic states) import almost 100% of their gas supplies from Russia. Some commentators see the energy relationship between Russia and the EU more as one of inter-dependency than of unilateral dependency of the EU. Indeed, in particular for its gas exports, Russia relies strongly on EU demand, since 54% of its energy exports go to the EU. This can be explained not only by the infrastructure in place, but also by the long-term contracts with guaranteed prices, which are needed to ensure the necessary investment in Russia's aging hydrocarbon infrastructure.

From the Russian point of view, the following issues are the cause of blockages in smooth bilateral trade relations:

Russian expectations on energy trade rules

In November 2009, Russia withdrew its signature from the Energy Charter Treaty – a multilateral agreement on energy investment, trade and transit. Judging it biased towards consumer countries, Russia has called for a new agreement or a drastically revised Energy Charter.¹⁴

In parallel, Russia is requesting special treatment under EU energy rules. First it wants to be exempt from EU moves to liberalise its energy market. The Russian side wants to continue with long-term gas contracts with prices linked to oil, meaning quite limited flexibility. Predictability is desired in order to raise money for new investment to replace aging gas and petrol fields.

The Russians are particularly critical of the EU's [third energy package](#) and in particular the requirement for all companies on the EU

energy market to run their supply, transport and sales business separately. This would mean for example that Gazprom has to sell access to the pipelines it owns on EU territory. As stated by then Prime Minister Vladimir Putin during his visit to Brussels in March 2011, implementation of the third energy package would lead to "confiscation" of Russian property on EU territory.¹⁵

Visa-free travel for Russian citizens in EU

Visa-free movement of people is a key Russian demand from the EU. In 2011 significant steps were taken in this area, with agreement on a set of common steps towards a visa-free regime, which include the promotion of biometric passports and fight against illegal immigration. In the mean time, an agreement was reached on the use of long-term, multiple-entry visas.

Further reading

Partnership with Russia in Europe: concrete steps towards cooperation between Russia and the EU, FES, 2011.

Russia and the WTO: expert debates and controversies, ICEUR Working Papers no 4, 2011.

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Endnotes

¹ Different sources provide slightly different data. Here we use BP Statistical Review of World Energy, June 2011.

² Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Kazakhstan, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.

³ Casier, Tom, Russia's Energy Leverage over the EU: Myth or Reality? *Perspectives on European Politics and Society*, 2011, 12:4, p. 500.

⁴ Garanina, O., What beyond Oil and Gas? Russian Trade Specialisation in Manufactures, *Post-Communist Economies*, 2009, 21(1), p. 12.

⁵ Globalisation, trade and the euro area macroeconomy/ ECB Monthly Bulletin, January 2008, p. 3.

⁶ Global patterns of trade specialisation and club convergence: Past and current patterns of trade specialisation (Challenges for Europe in the world in 2025/ Stöllinger, R.

⁷ EU-Russia Relations - One year after the Partnership for Modernisation/ Cwiek-Kaczmarek, J., *The Bulletin*, Polish Institute of International Affairs, no 61, 7 June 2011.

⁸ Lavrov opposes EU attempts to impose "WTO plus" regime on Russia/ Interfax, 21 March 2012.

⁹ Russia and the WTO: expert debate and controversies/ ICEUR, no 4, 2011.

¹⁰ Decoding Russia's WTO Accession/ Fean, D., *Russie. Nei. Visions*, no 64, February 2012.

¹¹ Russia's natural gas dilemma/ Stratfor, April 2012.

¹² Russia's export TRQs under the EU-Russia bilateral wood agreement – an opportunity for the EU industry/ EC Trade, February 2012.

¹³ Russian ban on livestock imports breaches WTO rules -EU/ Reuters, 20 March 2012.

¹⁴ Russia says 'no' to Energy Charter, urges new agreement/ 22 May 2009.

¹⁵ The EU and Russia: All smiles and no action?/ Barysch, Katinka, in: CER policy brief, April 2011.