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NO 93 / AUGUST 2008

RUSSIA, EU ENLARGEMENT AND THE EURO

by Zbigniew Polański
and Adalbert Winkler



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ABSTRACT

This paper reviews selected aspects of economic relations between the EU and Russia, focusing on the impact that the last two waves of EU enlargement have had on Russia, as well as the role of the euro in Russia. The analysis suggests that if EU enlargement has had any diversion effects on trade between the EU and Russia at all, they have been minimal, while robust growth in both the EU and Russia, as well as high oil and gas prices, has boosted trade. Likewise, FDI to and from Russia has increased, with the direct impact of enlargement again difficult to disentangle from other factors. Use of the euro by Russian residents and authorities in international transactions has increased, albeit at an uneven pace. While, in general, the US dollar remains the major foreign currency used by Russian residents, the euro has gained importance as an anchor and reserve currency in Russian exchange rate policies. This has happened in the context of an overall monetary policy strategy aiming at a gradual shift from an exchange rate-oriented monetary policy to inflation targeting.

JEL codes: F14, F15, F21, F36

Keywords: Economic integration, trade diversion, foreign direct investment, international currencies

EXECUTIVE SUMMARY

The introduction of the euro in 1999 and the subsequent enlargement of the euro area by four countries, as well as the two waves of EU enlargement in 2004 and 2007, have been milestones of European integration. This paper aims to provide an assessment of the effects that EU enlargement and the introduction of the euro have had on Russia, the largest country neighbouring the EU. In particular, it focuses on trade and investment links between the EU and Russia, as well as the use of the euro by Russian residents and authorities.

Economic links between Russia and the EU are found to have strengthened considerably in the areas of trade, investment and other financial flows in recent years. Strong growth, particularly in Russia, as well as the high price of oil and gas, Russia's major export items, has facilitated this expansion of trade and finance. Moreover, available data do not suggest that EU enlargement has had a negative impact on Russia in terms of trade or investment diversion. Thus, the strategic partnership between Russia and the EU has been increasingly underpinned by an expansion of cross-border economic activities.

In monetary terms, the euro has gained importance as an anchor and reserve currency in Russia. The efforts of the Central Bank of the Russian Federation to move towards a more flexible managed float, against the background of the medium-term goal to switch to an inflation targeting framework, may have been the most important reason for the more pronounced role of the euro in current Russian monetary policy-making. By contrast, the US dollar has remained the preferred international currency for investment and financing, as well as for invoicing and foreign exchange trading, given its strong role as an invoicing currency in global oil markets.

I INTRODUCTION

The introduction of the euro in 1999 and the subsequent enlargement of the euro area by four countries, as well as the two waves of EU enlargement in 2004 and 2007, have been milestones of European integration. While research has been conducted into the impact of these events on both the European and the global economies,¹ there have been few attempts to assess the effects of EU enlargement and the introduction of the euro on countries such as Russia, which neighbour the EU but currently have no perspective of accession.²

Against this background, this paper reviews the developments in economic, financial and monetary links between the EU and Russia – the largest country neighbouring the European Union and a strategic partner – with a focus on the economic impact of the two recent EU enlargements and the use of the euro by Russian authorities and residents.³ Thus, the paper contributes to two broad strands of literature on this subject, namely the impact of regional trade and economic arrangements on non-member countries and the international role of currencies. Above all, it aims to answer two questions:

- Have trade, investment and other financial links between the EU and Russia benefited from EU enlargement owing to the creation of a larger market, or have diversion effects prevailed?
- Have Russian authorities and residents made more use of the euro in international transactions, and what have been the main drivers in this process?

The paper is structured as follows: Sections 2 and 3 focus on the impact of EU enlargement on trade and financial links between the EU and Russia. Recent developments in the use of the euro in Russia are reviewed in Section 4. The paper ends with concluding remarks in Section 5.

1 See, for example, Buch and Piazzolo (2001), Bureau of European Policy Advisers and the Directorate-General for Economic and Financial Affairs (2006), Di Mauro and Anderton (2007), European Commission (2008) and Padoa-Schioppa (2005a). The evolution of the international role of the euro has been documented in the annual “Review of the international role of the euro”, published by the ECB since 2001.

2 Exceptions include Glinkina and Kulikova (2007) and Havlik (2007).

3 For a general overview of economic and financial relations between the euro area and Russia, see ECB (2005b).

2 TRADE BETWEEN THE EU AND RUSSIA: THE IMPACT OF EU ENLARGEMENT

2.1 TRADE BETWEEN THE EU AND RUSSIA: STRUCTURAL FEATURES AND RECENT DEVELOPMENTS

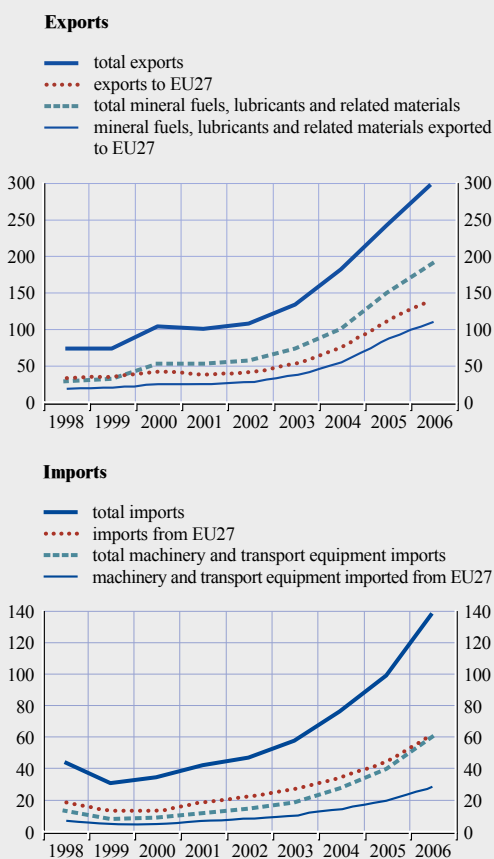
Russia's trade has been expanding rapidly in recent years, driven by the rising price of oil and gas, the country's major export items. The country's share in global trade roughly doubled from around 1% in 1998 to 2% in 2007.⁴ Even compared with other emerging market economies, which – as a group – have been gaining market shares at the expense of industrialised economies (Lane and Milesi-Ferretti, 2008), Russia's role

in international trade has been strengthening in recent years.

Since 1998, the year of the financial crisis and a post-1973 trough in oil prices on global markets, Russian exports – expressed in current US dollars – have more than quadrupled. Reflecting rising oil and gas prices, the share of fuels in total exports rose from around 39% in 1998 to more than 62% in 2006.⁵ Imports more than tripled, with particularly strong demand for machinery and transport equipment, whose share in total imports increased from around 28% in 1998 to more than 43% in 2006 (Chart 1).⁶ However, imports have remained significantly below the level of exports. As a result, the surplus in Russia's trade balance rose from around USD 28 billion in 1998 to more than USD 160 billion in 2006.

Chart 1 Russian exports and imports

(1998 – 2006; USD billions)



Source: Comtrade.

The EU is Russia's most important trading partner. According to IMF data, the EU accounted for approximately 53% of Russia's trade (i.e. the sum of its merchandise exports and imports) in 2007, around 6 percentage points higher than in 1998. The EU is not only the major destination of Russian exports, but also the major origin of Russian imports. In 2007 53% of Russian exports were bound for the EU, up from 47% in 1998, while the EU share in total Russian imports rose from approximately 44% in 1998 to more than 52% in 2007.

Russia's exports to the EU are more concentrated than total exports. In 2006 fuels and related items made up 78% of Russian exports to the EU, up from 55% in 1998. By contrast, at around 43%, the share of machinery and transport equipment in Russian imports from the EU is almost

4 Figures for Russian trade and trade between the EU and Russia provided in this section have been calculated on the basis of data published by Comtrade, Eurostat or the IMF.

5 At constant prices, the increase was more subdued. Beck, Kamps and Mileva (2007, p. 7) report that the share of oil in total Russian exports rose from 31.0% in 2000 to 43.4% in 2005 at current prices, while at constant prices the increase was only from 31.0% to 37.6%.

6 Barisitz and Ollus (2007) show that imports of machinery and equipment from the EU25 alone now exceed the level of domestic production, possibly indicating a case of Dutch disease in the Russian non-fuel sector (see also Beck, Kamps and Mileva (2007) and Oomes and Kalcheva (2007)).

Table 1 Main trading partners of Russia and the EU in 2007

(percentages of total trade)

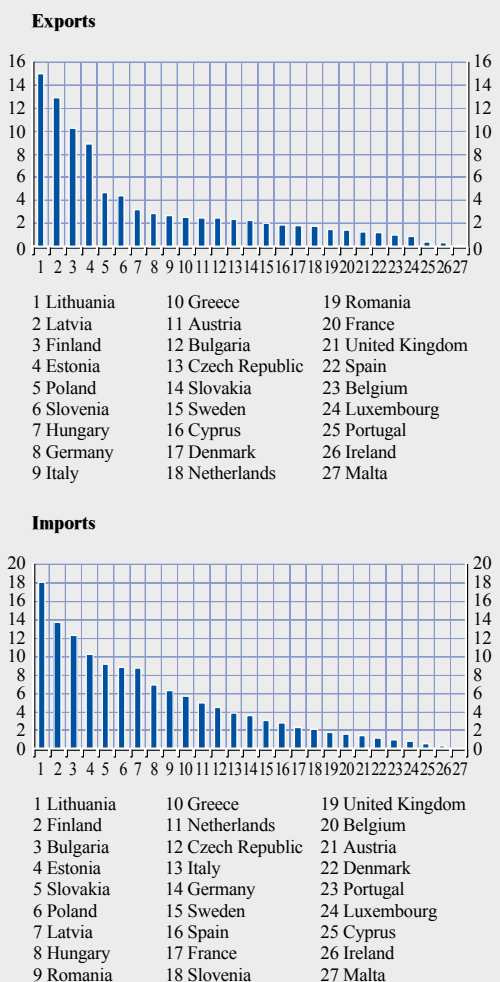
Russia		EU	
Exports	Imports	Exports	Imports
EU	53.0	EU	52.2
Turkey	6.1	China	12.5
China	5.0	Ukraine	5.0
Ukraine	4.4	Japan	4.8
Belarus	4.4	Belarus	3.9
		United States	21.1
		Switzerland	7.5
		Russia	7.2
		China	5.8
		Turkey	4.2
		China	16.2
		United States	12.7
		Russia	10.1
		Japan	5.8
		Switzerland	5.6

Sources: IMF, Eurostat and ECB calculations.

identical to the share of machinery and transport equipment in total Russian imports.

Chart 2 EU countries' exports and imports to Russia in 2007

(as a share of total EU countries' exports and imports; in percentages)



Sources: IMF and authors' calculations.

In 2007 Russia was the EU's third largest trading partner, with a share of more than 7% in exports and a 10% share in imports (Table 1). Compared with the late 1990s, the importance of Russia in EU trade has more than doubled, reaching 7.9% in 2007. In terms of the major commodities traded, Russia accounts for 7% of total EU exports of machinery and transport equipment, up from less than 2% in 1999, but more than 28% of total EU imports of fuel and related items. Since 1999 the latter share has risen by more than 6 percentage points.

The largest EU countries – Germany, Italy, France, the United Kingdom and Spain – are, together with the Netherlands and neighbouring Finland and Poland, Russia's major trading partners in the EU. Conversely, Russia's share in the trade of individual EU countries is by far the highest in Lithuania and the other Baltic states. Finland and other new Member States follow, while Russia's share in the total trade of the larger EU Member States, such as Germany, France, the United Kingdom and Italy, is less than 3% for exports and less than 5% for imports (Chart 2).

2.2 TRADE EFFECTS OF PREFERENTIAL TRADE ARRANGEMENTS: THEORY AND EMPIRICAL EVIDENCE

Traditional trade theory (Viner, 1950) suggests that the direct effect of EU enlargement on trade between a Member State and Non-Member State, such as Russia, is a dual one. Among the Member States of the enlarged EU, trade will be supported by the abolition of all trade barriers and the enlargement of the single

market (trade creation). At the same time, according to the theory, trade between the enlarged EU and Russia should decline, as tariffs and non-tariff barriers remain in place, putting Russia – like any other country outside the EU – at a disadvantage in its trade both with the EU15 and with the Member States in central, eastern and south-eastern Europe (trade diversion).⁷

Trade diversion effects may be outweighed by market size and income effects, suggesting that non-member countries may also benefit from regional integration arrangements. In the case at hand, the enlarged EU internal market should raise efficiency and income levels, which may increase the demand for goods and services both inside and outside the EU. Non-EU countries may also face lower transaction costs for exports to the EU, as harmonised rules and regulations apply for a larger market, thereby raising efficiency.

A great deal of literature aims to measure the trade creation and trade diversion effects of existing regional trade arrangements. Results range from almost no effect to significant creation and diversion effects in line with standard theory.⁸ Empirical studies and simulations looking at the impact of the process of EU enlargement on trade between the EU and Russia suggest that effects have been minimal at best. For example, for the period 1993-2002, when trade liberalisation between the EU and central and eastern European countries advanced significantly on the basis of the European and Interim Agreements, the gravity model estimated by Mordonu (2006) shows no evidence of trade diversion for Russian exports to the EU15 and the former accession countries. Also on the basis of a gravity model, Alho (2003) even reports a positive impact on Russian exports to the central and eastern European Member States, while Wilhelmsson (2006) finds limited trade diversion effects owing to EU enlargement. Sulamaa and Widgrén (2004) simulate the impact of the recent EU enlargement on Russia on the basis of the Global Trade Analysis Model

(GTAP). Their results suggest that the impact of enlargement on Russia is negligible in terms of growth, slightly negative for imports, but again positive for exports. Similarly, research by Vinhas de Souza (2004) suggests that the main beneficiaries of the 2004 enlargement were the EU10 countries, while the impact on Russia and other EU neighbouring countries was marginal.

2.3 CHALLENGES IN IDENTIFYING THE IMPACT OF EU ENLARGEMENT ON TRADE BETWEEN THE EU AND RUSSIA

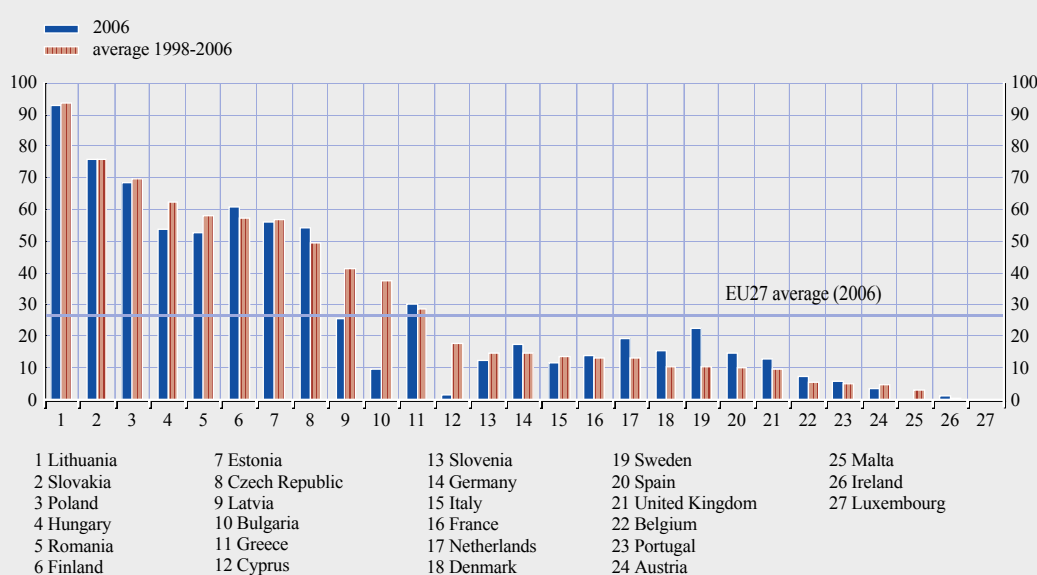
It is difficult to trace possible trade diversion effects in post-2004 trade between the EU and Russia, as – in parallel – substantial changes have been taking place in the structure of global trade. These include the increasing integration of emerging market economies – particularly those of emerging Asia – into the global economy, as well as the rising price of oil and gas, Russia's major export items. Moreover, strong growth in Russia and the expansion of the euro area have provided an extra boost to trade between the EU and Russia in recent years. Finally, the liberalisation of trade between the EU and the former accession countries had started well before 2004. Thus, trade diversion effects may have already occurred, while any additional impact of the 2004 enlargement would have to be traced back to the expansion of the single market.

The impact of the rise in oil and gas prices may be the most difficult to account for when analysing

7 There have been very few studies analysing the impact of currency unions on non-members (Bayoumi (1994) is an exception). Implicitly, the work by Rose (2000) on the endogeneity of optimum currency areas suggests that a currency union would have trade creation and trade diversion effects similar to those of a free trade area, a customs union and a single market. Micco, Stein and Ordóñez (2003), as well as Baldwin, Skudelny and Taglioni (2005), suggest that the introduction of the euro has led to increased trade not just among euro area members, but also between the euro area and the rest of the world.

8 See, for example, Carrère (2006). Measuring the trade creation and diversion effects of regional integration is a challenge, as it has proven inherently difficult to distinguish the effect of regional integration on trade among members and between members and non-members from other factors (Eicher, Henn and Papageorgiou, 2007).

Chart 3 Share of Russia in EU countries' imports of mineral fuels, lubricants and related materials



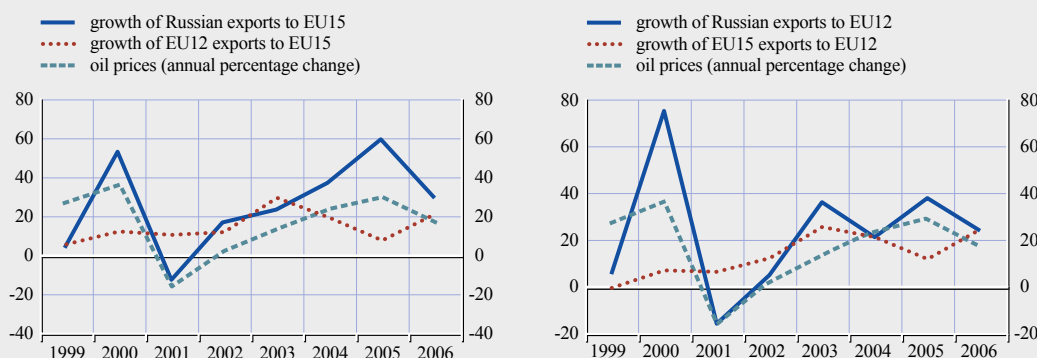
Sources: Comtrade, Eurostat and authors' calculations.

the impact of EU enlargement on trade between the EU and Russia.⁹ While imports from Russia account for approximately 28% of total EU imports of mineral fuels, the dominance of Russia as a supplier of mineral fuels is much more pronounced in the EU Member States of central, eastern and south-eastern Europe, with the share of Russian imports reaching more than 50% in seven countries (Chart 3).

9 This is also because data on bilateral trade are only available in terms of values, not volumes; see Barisitz and Ollus (2007). Thus, it is not possible to track possible trade diversion effects in real terms. It should also be mentioned that gas prices rose, in particular for some of the new EU Member States, because Russia increased the gas prices charged to former Soviet republics from the low levels charged previously. As a result, the Baltic countries, while still paying lower gas prices than other EU customers in 2005-06, faced the highest prices of all the former Soviet republics (Czarny and Toporowski, 2008). Comtrade data suggest that the Baltic countries, Slovakia, Romania and Finland import more than 80% – some of them even close to 95% – of their gas from Russia.

Chart 4 Growth of Russian, EU15 and EU12 exports to the EU15/EU12

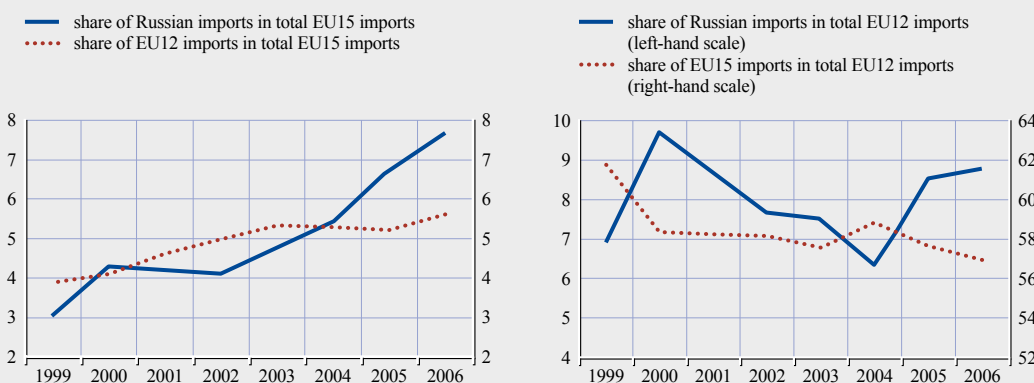
(1999 – 2006; annual percentage changes)



Source: IMF.

Chart 5 Share of Russian and EU15/EU12 imports in total EU15/EU12 imports

(1999 – 2006; in percentages)



Source: IMF.

Slower growth in Russian exports to the EU15 and the new Member States in central, eastern and south-eastern Europe (EU12) following enlargement might have been indicative of corresponding trade diversion effects, in particular if it were accompanied by a rise in export growth among the EU sub-groups. However, since 2001 the growth rate of Russian exports to the EU15 has been higher than that of EU12 exports to such countries, and the growth rate of Russian exports to the EU12 has been higher than that of the EU15 exports to those countries (Chart 4). Prima facie, this suggests that enlargement has not been diverting Russian exports to the old or new Member States as a consequence of the creation of trade between new and old Member States.

At the same time, however, oil price developments seem to have played an important role in explaining the growth rates of Russian exports to the EU15 and the EU12. As indicated in Chart 4, the growth rates of Russian exports to the EU15 and EU12 have been closely following changes in global oil prices. Thus, the strong performance of Russian exports to the EU after enlargement might largely reflect the rise in oil and gas prices, making it difficult to draw strong conclusions as to possible trade diversion effects.

Oil price developments may also distort the analysis when focusing on the shares of Russian

and EU12/EU15 imports in total EU15/EU12 imports. The share of imports from Russia in total EU15 imports has been rising since 2002, i.e. with the rise in oil prices (Chart 5, left panel). For total EU12 imports (right panel), the raw data provide a less clear-cut message, as the share of Russian imports in total EU12 imports fell quite markedly between 2000 and 2004. However, it is again difficult to draw strong conclusions from this, as the share of the EU15 in total EU12 imports was relatively stable over the same period. When oil price increases accelerated in 2004-05, the share of Russian imports in total EU12 imports rose again. This underlines the dominant influence of oil price developments on movements in the share of Russian imports in the total imports of the new Member States in central, eastern and south-eastern Europe.

2.4 SUMMARY

The enlarged EU is Russia's most important trading partner, with energy dominating Russia's exports to the EU and manufacturing products being the EU's major export item to Russia. While, according to traditional trade theory, the effect of enlargement on trade between the EU and Russia would be trade diversion, this may be offset by positive market size and income effects.

It is difficult to capture the effects of EU enlargement on trade between Russia and the

EU. Econometric studies based on ex ante and ex post calculations, the latter reviewing the period of increasing trade liberalisation between the EU and the former accession countries before 2004, suggest that the trade diversion effects of EU enlargement on trade between the EU and Russia should have been marginal. Actual post-2004 trade data show a substantial increase in trade between the EU and Russia after enlargement, both in absolute and relative terms. However, this does not rule out the occurrence of diversion effects as suggested by traditional theory, as these effects could have been offset by rising trade, reflecting strong growth in Russia and the EU, as well as the rise in oil and gas prices.

3 INVESTMENT AND OTHER FINANCIAL FLOWS BETWEEN THE EU AND RUSSIA: THE IMPACT OF EU ENLARGEMENT

Economic theory does not provide clear guidance on the implications of regional economic integration on FDI flows among members and between members and non-members of a regional agreement (de Sousa and Lochar, 2004). Empirical studies suggest that regional integration arrangements reinforce FDI flows between member countries, with some possible diversion effects (Levy Yeyati, Stein and Daude, 2003). For extra-regional FDI (investment flows from non-member countries to member countries), theory is less ambiguous, predicting that members will become more attractive destinations for non-member FDI inflows, as FDI is one of the main ways to enter the common market by establishing affiliates in member countries.¹⁰

Over the last few years Russian investment flows vis-à-vis the rest of the world have increased substantially. Total accumulated inward investment in Russia nearly quadrupled from USD 57.0 billion at end-2003 to USD 220.6 billion at end-2007.¹¹ In parallel, investment outflows from Russia more than sextupled, albeit from a low level, from USD 5.2 billion to USD 32.1 billion. Meanwhile, the structure of investment flows between Russia and the rest of the world has been relatively stable. FDI and other investment (mainly loans and trade credits) have dominated, while portfolio flows account for only 3% of total inflows and less than 8% of total outflows. The service sector, in particular trade, has been the

main target of FDI inflows to Russia in recent years, accounting for approximately 55% of total FDI inflows between 2003 and 2007, followed by manufacturing, receiving around 25% of FDI inflows, and mining and quarrying (Vinhas de Souza, 2008, p. 69).

With enlargement, the EU has become Russia's largest single FDI partner, in terms of both inflows and outflows. At end-2007 the EU accounted for almost 80% of Russia's inward FDI stock,¹² while nearly 72% of Russia's outward FDI stock had been invested in the EU (Tables 2 and 3, and Chart 6). The respective shares of other countries, such as the United States and Ukraine, either declined or stabilised at low levels.

The increasing importance of the EU as the source and destination of Russian FDI mainly reflects the fact that Cyprus and Lithuania have been major sources and/or destinations of Russian FDI. While Cyprus has been an important source and host country of Russian FDI, Lithuania has been a major destination of Russian outward FDI, particularly in 2005-06. Moreover, a significant proportion of FDI flows between the EU and Russia seems to

10 Concerning the impact of monetary union on FDI, the main theoretical propositions refer to the positive impact that eliminating exchange rate risk and transaction costs has on FDI flows among member countries (Wei and Choi, 2002). Empirically, de Sousa and Lochar (2004) find European Economic and Monetary Union to be associated with increasing FDI flows within the euro area and between the euro area and other OECD countries.

11 The analysis of Russian investment flows is based on stock data provided by the Federal State Statistics Service (Rosstat).

12 FDI stock refers to equity capital, reinvested earnings and loans (registration data) in the non-financial sector.

Table 2 Inward FDI stock from selected EU countries

(as a share of total Russian inward FDI stock; 2003 – 2007; in percentages)

	2003	2004	2005	2006	2007
EU15 ¹⁾	33.4	38.6	44.7	39.9	44.5
EU25/27 ²⁾	52.6	66.5	72.7	73.5	78.9
Memo: United States	16.4	11.9	8.8	6.8	3.5

Source: Federal State Statistics Service (Rosstat).

1) France, Germany, Luxembourg, the Netherlands and the United Kingdom. Austria included in 2004 and Ireland in 2007.

2) As above, plus Cyprus.

Table 3 Outward FDI stock to selected EU countries

(as a share of total Russian outward FDI stock; 2003 – 2007; in percentages)

	2003	2004	2005	2006	2007
EU15 ¹⁾	17.7	44.1	25.5	36.7	58.4
EU25/27 ²⁾	19.6	45.6	35.0	62.6	71.9
<i>Memo: United States</i>	-	6.6	11.1	9.6	8.1
<i>Memo: Ukraine</i>	-	1.4	3.2	1.5	0.9

Source: Federal State Statistics Service (Rosstat).

1) 2003 – the Netherlands; 2004 – the Netherlands and the United Kingdom; 2005 – Austria, the Netherlands and the United Kingdom; 2006 – Austria, Germany, Luxembourg, the Netherlands and the United Kingdom; 2007 – Austria, Germany, the Netherlands and the United Kingdom.
2) 2003 – Cyprus, Lithuania and the Netherlands; 2004 – Cyprus, the Netherlands and the United Kingdom; 2005 – Austria, Cyprus, Lithuania, the Netherlands and the United Kingdom; 2006 – Austria, Cyprus, Germany, Lithuania, Luxembourg, the Netherlands and the United Kingdom; 2007 – Austria, Cyprus, Germany, the Netherlands and the United Kingdom.

reflect a reinvestment of Russian capital, in particular via Cyprus.¹³ However, the growing importance of the EU as a source of greenfield investment in Russia (UNCTAD 2006, pp. 78-82) suggests that its increasing role in overall FDI flows does not just reflect reinvestment of Russian capital.

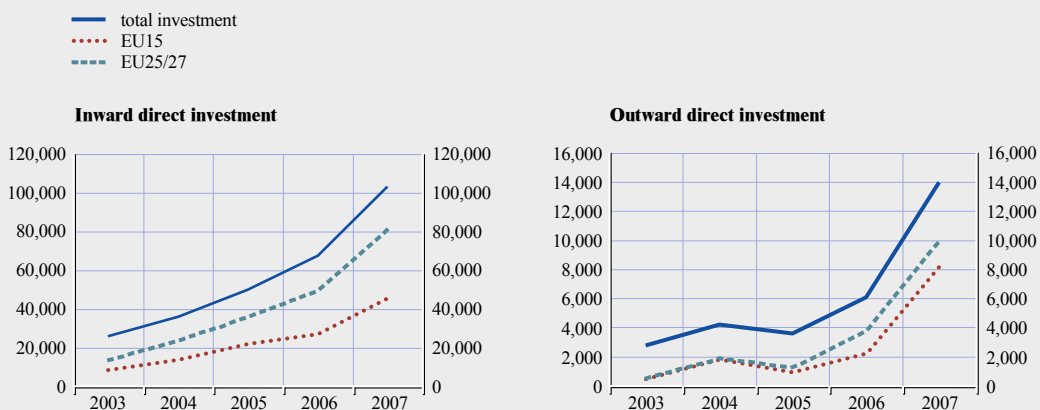
Most recently (Chart 6, right panel), FDI flows from Russia to the EU have increased substantially. However, as with trade flows, it is difficult to assess whether this is due to EU enlargement, i.e. a sign of the increasing attractiveness of the enlarged EU as a destination of FDI inflows, or a reflection of other factors, such as strong growth and rising wealth in Russia.

Turning to portfolio investment, over 65% of foreign portfolio investment in Russia was held by EU investors at end-2007. Cyprus accounts for the second largest share in the total stock (after the United Kingdom), confirming its role as a major offshore-banking centre. By contrast, portfolio investment in the EU by Russian investors has been limited. At end-2007 the EU accounted for slightly more than 8% of total portfolio investment abroad by Russian residents, with non-EU countries (the Virgin Islands and Ukraine) being the main destinations.

13 See also OECD (2006, pp. 16-17), UNCTAD (2006, p. 106 and p. 115), Hunya (2007, p. 9), BOFIT (2008c) and Vinhas de Souza (2008, p. 67). These “round-tripping”, or “recycling of money”, activities have also been observed in other key emerging market countries, such as India (via Mauritius) and China (via Hong Kong) (Lane and Schmukler, 2006).

Chart 6 Russian inward and outward FDI stock

(2003 – 2007; in USD millions)



Source: Federal State Statistics Service (Rosstat).

Notes: “EU15” and “EU25/27” comprise the countries mentioned in the footnotes to Tables 4 and 5.

Even before the 2004 and 2007 enlargements, the EU was the most important source of “other” investment in Russia (mostly loans and trade credits) – at the end of 2003 the EU supplied at least 68% of this type of investment. Over time the EU share has continued to increase, reaching nearly 78% of the total stock of “other” investment in Russia at end-2007. Luxembourg has been the main source of “other” investment since 2004, accounting for a share of 25.5% at end-2007. “Other” outward investment rose significantly with EU enlargement, since Cyprus is the main destination for this type of investment by Russian residents (50.9% of the total stock at end-2007), followed by the Virgin Islands (22.1%) and Austria (6.8%).

Flows in the form of remittances are not a crucial position in the Russian balance of payments. In 2004 the ratios of gross remittances (i.e. the sum of out- and inflows) to imports of goods and services, as well as to FDI, were below the levels seen in other emerging market and developing economies (ECB, 2007a). The same applies to remittances received, expressed as a percentage of Russian GDP (World Bank, 2006, p. 6). Net remittances are a negative item in the Russian balance of payments, as Russia has become a migration destination for citizens of other CIS countries (World Bank, 2006, pp. 46-49). Moreover, outflows of remittances could also reflect financial support provided by Russian residents to Russian minorities living abroad.

With enlargement, the EU has become a more important source of remittances flowing to Russia. Remittances flowing to Russia from the EU account for roughly one-fifth of total remittance inflows (Table 4). Transfers of remittances from Russia to the EU are of much less importance, even though they increased slightly in absolute terms with recent EU enlargements. Thus, Russia is a net recipient of remittances from the EU. However, this reflects two different trends, namely a net inflow from the EU15 countries, but net outflows to some of the countries that recently joined the EU.

In conclusion, the EU is the largest investor in Russia and its weight has further increased, both in absolute and relative terms, after enlargement. However, a substantial part of this investment originates from financial centres, indicating a reinvestment of Russian capital. At the same time, there has been a rise in Russian investment in the EU, albeit from low levels. While this is in line with considerations made in the literature concerning the impact of economic integration on investment by non-member countries, the dominance of financial centres as destinations for Russian foreign investment calls for caution in linking the recent trends to market size effects which are related to enlargement.

Table 4 Remittances between the EU and Russia via money transfer systems and post offices

(2006 – 2007; in percentages of remittances to and from Russia, as registered by the money transfer systems and post offices)

	2006 (Q2-Q4)	2007
Remittances from the EU to Russia		
EU15 ¹⁾	20.5	17.2
EU25 for 2006 and EU27 for 2007 ²⁾	22.2	19.3
Remittances from Russia to the EU		
EU15 ¹⁾	1.3	1.1
EU25 for 2006 and EU27 for 2007 ²⁾	1.8	1.8

Source: Central Bank of the Russian Federation (<http://www.cbr.ru/eng/statistics/CrossBorder/>).

Notes: Data for 2006 refer to the period April-December.

Remittances via money transfer systems and post offices are only a part of total remittances flowing between Russia and the rest of the world. Available information suggests, however, that these flows have increased substantially in recent years, making them a gradually more important part of all cross-border transactions conducted by individuals (CBR, 2007a).

1) Austria, Belgium, France, Germany, Greece, Italy, the Netherlands (only in 2006), Spain and the United Kingdom.

2) For 2006 reported EU25 countries are those mentioned above, as well as the Czech Republic, Latvia, Lithuania and Poland. For 2007 “EU27” comprises the EU25 as detailed above, plus Bulgaria.

4 THE ROLE OF THE EURO IN RUSSIA

4.1 THE EURO AS AN INTERNATIONAL CURRENCY: A GENERAL FRAMEWORK

Since its introduction, the euro has been used not only by euro area residents, but also by authorities and private agents outside the euro area. Internationally the euro serves as: (1) an anchor, reserve or intervention currency used by authorities in third countries; (2) a parallel currency in the form of cash, domestic bank deposits and loans used by households and firms; (3) a vehicle currency in foreign exchange markets;¹⁴ (4) an invoicing currency in international trade; and (5) the currency of denomination for various financial assets held (investment currency) and issued (financing currency) outside the euro area.

Globally, the euro is the second most widely used international currency after the US dollar, with a clear regional focus on countries in the immediate vicinity of the euro area.¹⁵ As an anchor, reserve and intervention currency, as well as an invoicing and parallel currency, the euro is used much more by authorities and private agents in the vicinity of the euro area than in other parts of the world. This reflects the strong economic, financial and institutional linkages between the respective countries and the euro area.

The main economic factors underpinning the internationalisation of a currency are a low inflation rate, a high degree of openness to international trade and finance, and a well-developed financial system with deep and liquid markets.¹⁶ However, a variety of additional factors also help to explain why given authorities and private agents in third countries use international currencies. For example, countries with a peg or tightly managed float need an anchor currency, the choice of which largely determines the main reserve and intervention currency of the respective country.

The choice made by private agents to use an international currency is mainly determined by¹⁷:

- hedging behaviour, as well as efforts to diversify the investor base and to exploit opportunities to arbitrage financing costs across currencies (financing currency);
- differences in liquidity and transaction costs, as well as network effects (vehicle and invoicing currency);
- the degree of homogeneity of goods traded internationally, the size of the respective trading partners, market power of firms and the elasticity of demand (invoicing currency);
- past macroeconomic instability and the volatility of inflation, geographical proximity and the presence of foreign banks (parallel currency).

4.2 THE ROLE OF INTERNATIONAL CURRENCIES IN POST-SOVIET RUSSIA – A QUICK REVIEW OF THE 1990s AND EARLY 2000s

In the 1990s the US dollar was the dominant international currency in Russia, serving as an anchor, reserve and intervention currency, in particular under the exchange rate peg operated between 1995 and 1998. Moreover, reflecting severe macroeconomic instability in the early years of transition, cash and asset substitution based on the US dollar was widespread (Oomes, 2003).¹⁸

After the financial crisis of August 1998 and the collapse of the peg, the Central Bank of the Russian Federation (CBR) soon reintroduced an exchange rate-based monetary policy in the form

¹⁴ A vehicle currency (B) is defined as a currency used in the foreign exchange market as a means of exchanging two other currencies, so that currencies A and C are not exchanged directly (A-C) but via B in two transactions (A-B and B-C).

¹⁵ For details, see the annual “Review of the international role of the euro”, published by the ECB.

¹⁶ See the overview in Flandreau and Jobst (2006).

¹⁷ See various issues of the “Review of the international role of the euro”, as well as Pollard (2001), Siegfried, Simeonova and Vespro (2007) and Mileva and Siegfried (2007).

¹⁸ The Federal Reserve estimates suggest that in 2002 the value of US dollar cash circulating in Russia and other countries of the former Soviet Union stood at around USD 178 billion, roughly 29% of total international holdings of US currency (Botta, 2003).

of a tightly managed float with the US dollar serving as the anchor currency. This was evidenced by strong reserve accumulation, the smooth development of the US dollar-rouble exchange rate and substantial fluctuations in interest rates on the domestic interbank market.¹⁹

4.3 THE EURO AS AN ANCHOR, RESERVE AND INTERVENTION CURRENCY IN RUSSIA

Starting in the early 2000s CBR officials indicated that, in the medium term, Russian monetary policy should pay less attention to exchange rate developments and focus more on inflation and liquidity in domestic financial markets, eventually leading to the adoption of an inflation targeting regime (ECB 2005a, CBR 2007b, Ignatiev 2007).²⁰ Such statements have been underpinned by reforms of the monetary policy framework and monetary policy instruments, allowing the CBR to play a more active role on domestic financial markets.²¹

Against this background, the CBR introduced two currency baskets consecutively as a benchmark for its operations. In February 2003 a trade-weighted currency basket for computing the nominal effective exchange rate of the rouble was introduced to monitor and set ceilings for the real appreciation of the rouble. Subsequently, in February 2005 an operational euro-US dollar basket became effective as a reference point for the daily management of the rouble's exchange rate.

The share of the euro in the trade-weighted currency basket has been relatively stable, fluctuating between 36% and 41% (Table 5).²² By

Table 6 The composition of the operational currency basket of the CBR

(2005 – 2007)	
Date of change	Euro-US dollar share
2005	
1 February	10:90
15 March	20:80
16 May	30:70
1 August	35:65
2 December	40:60
2007	
8 February	45:55

Source: Central Bank of the Russian Federation.

contrast, the share of the euro in the operational basket has been steadily increasing, rising from just 10% in February 2005 to 45% in February 2007, while that of the US dollar declined from 90% to 55% in that period (Table 6).²³

The increasing role of the euro as an anchor currency has had a marked impact on the volatility of the rouble against the euro, which is measured by the standard deviation of daily returns. Volatility has been declining significantly since 2004 and, in 2007, it

19 These are the typical characteristics associated with countries which have a “fear of floating” (Calvo and Reinhart, 2000).

20 Esanov, Merkl and Vinhas de Souza (2004) provide a summary of Russian monetary policy from 1993 to 2002.

21 See BOFIT (2002 a, b) and CBR (2003).

22 Reflecting recent enlargements, the weight of EU countries in the trade-weighted basket increased from 45.2% for the EU15 in 2004 to at least 57.9% in 2007. While the 2004 basket included all of the EU15, the 2007 basket included only 22 of the current EU Member States.

23 The basket is operated with fixed quantities (ECB, 2005c, p. 51) and, when computing its value, the actual current market exchange rates are taken into account. As a result, the changes in the market values of the currencies have an impact on the eventual composition of the basket (for details, see Schnabl, 2006).

Table 5 The share of euro area countries in the trade-weighted currency basket of the CBR

(2004 – 2007; in percentages)

	2004	2005	2006	2007
Euro area	38.9	36.4	36.8	40.6 ¹⁾

Source: Central Bank of the Russian Federation (http://www.cbr.ru/eng/statistics/credit_statistics/).

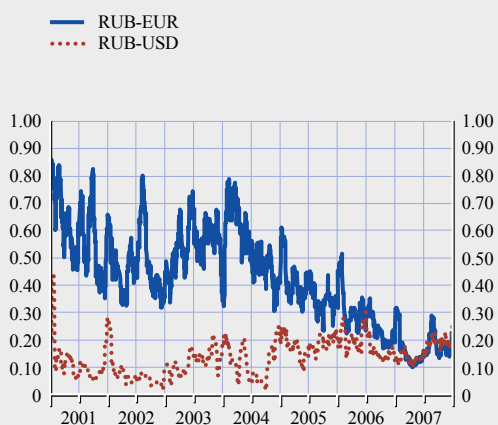
Notes: In 2003 the structure of the basket was changed on several occasions.

When computing the weights for the basket, the CBR takes into account Russian foreign trade turnover with its main partners (34-35 countries accounting for 81.0% to 87.3% of the total foreign trade turnover in the period under consideration). Customs statistics relating to trade developments two years earlier are taken into account.

1) Includes Slovenia.

Chart 7 Volatility of the rouble-US dollar and rouble-euro exchange rates

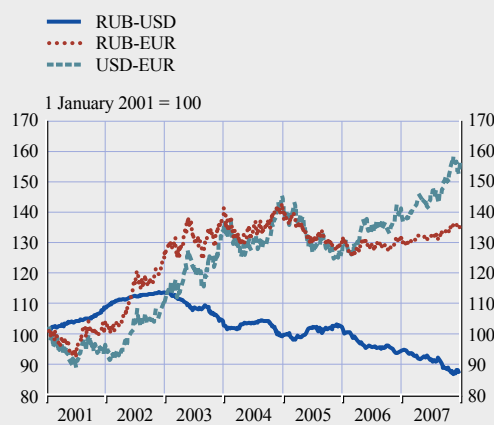
(2001 – 2007; 30-day moving standard deviation of daily exchange rate changes, including all calendar days)



Source: Bloomberg and author's calculations.

Chart 8 Rouble, euro and US dollar exchange rates

(2001 – 2007)



Sources: Bloomberg and authors' calculations.

converged with the degree of volatility of the rouble against the US dollar (Chart 7).

In terms of exchange rate levels, since the beginning of 2006 a change in pattern can be observed (Chart 8). While the rouble-euro exchange rate closely followed movements in the US dollar-euro exchange rate until end-2005, this relationship has loosened substantially since early 2006.

The increasing importance of the euro in the formulation of Russian exchange rate policy has been complemented by the rising share of euro-denominated assets in Russian official foreign exchange reserves. Since 2001 the CBR has increased the amount of reserve assets into euro-denominated instruments, gradually increasing the share of such instruments from around 10% of total reserves in 2001 to one-third in 2005, and to 42.4% at end-2007. The share of US dollar-denominated assets stood at 47.0% at end-2007, while assets denominated in pounds sterling (9.8%) and Japanese yen (0.8%) accounted for the remaining part of the reserve assets (CBR, 2008, p. 83). As Russia has become the third largest holder of foreign exchange reserves globally (USD 476.4 billion at end 2007), it can be assumed that Russia is one of the world's largest holders of

euro denominated foreign exchange reserves.²⁴ A substantial part of Russia's foreign exchange reserves represents funds accumulated by the Oil Stabilisation Fund (OSF), formally established in January 2004.²⁵ The OSF is managed by the CBR on behalf of the government²⁶, with assets invested with a currency breakdown of 45% US dollar, 45% euro and 10% pound sterling (Ministry of Finance, 2007).

In August 2005 the CBR began official intervention operations on the domestic rouble/euro market (Reuters, 2005). More recently,

²⁴ Most countries do publish the level, but not the currency composition, of foreign exchange reserves. Several countries, in particular in emerging Asia, do not even disclose the currency composition of foreign exchange reserves to the International Monetary Fund, and thus are not covered by the IMF COFER statistics (IMF, 2005). Therefore, it is not possible to provide a more precise assessment of the role of Russia in total euro-denominated foreign exchange reserves.

²⁵ Before 2004 the authorities made use of a "special reserve" to smooth the macroeconomic impact of oil price fluctuations. The OSF was mainly financed by two sources: oil export custom duties in excess of a reference price and the mineral extraction tax. In addition, the unspent fiscal surplus of the previous fiscal year was added to the OSF. In February 2008 the OSF was divided into the Reserve Fund and the National Welfare Fund (BOFIT, 2008a; OECD, 2008, p. 206).

²⁶ Assets held by the OSF were thus included in the foreign exchange reserves reported by the CBR. In 2007 the OSF accounted for around 33% of Russian foreign exchange reserves. See also ECB (2007c).

public statements by the CBR suggest that it has continued to intervene in the rouble/euro market, albeit on a substantially smaller scale than in the rouble/US dollar market (ECB, 2007b).

4.4 PARALLEL, VEHICLE, FINANCING AND INVESTMENT CURRENCY – THE CONTINUED DOMINANCE OF THE US DOLLAR

In contrast to its official use, available evidence suggests that the US dollar continues to be the preferred international currency used by Russian households and businesses, as well as Russian participants in global financial and goods markets.

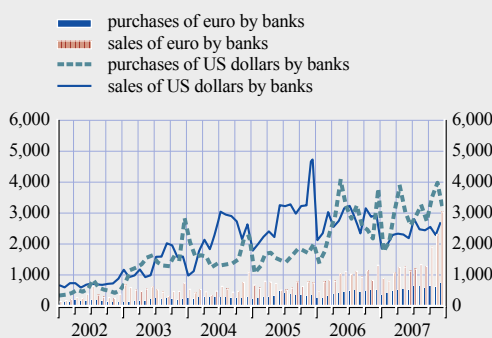
The US dollar remains the preferred parallel currency of Russian households (Korhonen and Merhrotra, 2007). While there are no official data on the currency composition of foreign exchange deposits and loans in the Russian banking system, the majority of these deposits and loans are assumed to be denominated in US dollars. However, with rising exchange rate stability and progress in macroeconomic stabilisation,²⁷ the share of foreign currency deposits in total deposits dropped from more than 32% at end-1999 to less than 13% at end-2007. The same trend can be observed for foreign currency loans, which fell from more than 70% of total loans at end-1998 to less than 24% at end-2007. Anecdotal evidence also suggests a decline in the use of foreign cash for domestic transactions.²⁸

Since the euro cash changeover in 2002 there have been signs of rising demand for euro cash relative to US dollar cash. For example, Russian banks have been consistently selling more euro cash than they purchase (Chart 9). While this might reflect demand for euro cash linked to Russian tourism activity, it could also point to a rise in the demand for euro cash for other purposes.

The volume of US dollar cash transactions between authorised banks and individuals in Russia has continued to surpass the corresponding level for euro. Particularly in periods of financial turbulence, for instance during the “crisis of

Chart 9 Volume of cash transactions in US dollars and euro between authorised banks and individuals in Russia

(2002 – 2007; USD millions)



Source: Central Bank of the Russian Federation.

confidence” in the summer of 2004,²⁹ a strong demand for US dollar cash can be observed. More recently, however, there have also been periods in which purchases of US dollar cash by banks have been significantly higher than sales, signalling a possible decline in demand for US dollar cash by Russian individuals.

Similar trends can be observed on the Russian foreign exchange market. The US dollar continues to be the principal foreign currency traded (see Chart 10), while the role of the euro has been gradually increasing since 2006. Closer analysis (Chart 11) reveals, however, that the rise of the euro mainly reflects the higher turnover of the euro against the US dollar. Focusing on the rouble exchange market only, the euro remains at less than 5% of total transactions, compared with more than 95% for the US dollar. Thus, the US dollar

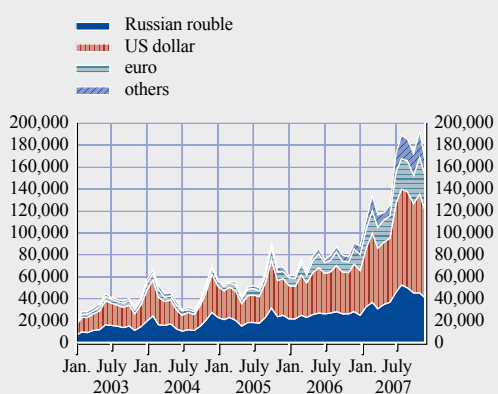
²⁷ Inflation dropped from 84.4% in 1998 and 36.5% in 1999 to 15.1% in 2002, and the government budget moved from a large deficit to a surplus.

²⁸ See also Harrison and Vymyatnina (2007). To some extent, the decline in the use of foreign cash has also been fostered by administrative measures. For example, in July 2007 a new law became effective banning – with some exceptions, in particular for real estate – domestic prices from being quoted in currencies other than the rouble (Moscow News, 2007). An analysis of the determinants of foreign currency pricing in Russia is provided by Levina and Zamulin (2006).

²⁹ In May 2004 the Russian banking system suffered a severe loss of confidence after the CBR had revoked the licence of a medium-sized bank for non-compliance with the law on money laundering. This decision triggered a run on the deposits of some banks and interventions by the CBR to counter a liquidity crisis on the Russian money market. For details, see CBR (2005).

Chart 10 Currency breakdown of total average daily turnover for spot transactions on the Russian foreign exchange interbank market

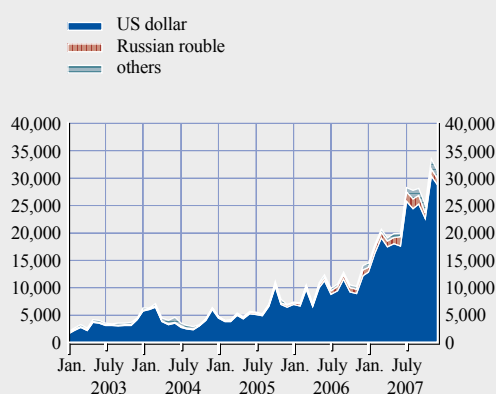
(2003–2007; in USD millions)



Source: Central Bank of the Russian Federation.

Chart 11 Currency breakdown of total average daily euro turnover for spot transactions on the Russian foreign exchange interbank market

(2003–2007; in USD millions)



Source: Central Bank of the Russian Federation.

remains the main foreign and vehicle currency traded on Russia's foreign exchange market.

No official data are available on the invoicing currencies used by Russian exporters, or the settlement and payment currencies for Russian imports and exports. However, market analysts (Tsepliaeva, 2007, p. 12) assume that – despite the EU being Russia's major trading partner (Table 1) – approximately 85% of Russian exports are invoiced in US dollars. This probably reflects the fact that oil, priced and invoiced in US dollars in global markets, is Russia's major export item.³⁰ On the import side, with heterogeneous goods mainly imported from the EU (sub-section 2.1), the role of the euro might be more pronounced. However, owing to a lack of official statistics, no assessment can be made.

The US dollar has also remained the preferred international financing currency of Russian borrowers, who have made extensive use of international capital markets in recent years (Table 7). For example, total funds raised via the international bond market grew from USD 2.3 billion in 2001 to USD 60.1 billion in 2007.³¹ Bonds denominated in US dollars accounted for

30 A detailed review of the empirical evidence regarding the market for crude oil and current oil invoicing practices can be found in Mileva and Siegfried (2007). In recent gas supply contracts signed with Baltic countries, Gazprom, Russia's largest gas company, has opted for euro invoicing (European Commission, 2008, p. 129).

31 Reflecting its strong fiscal position, the public sector has refrained from major issuance activities, while the private sector, against the background of rapid growth and rising investment, has been engaged in heavy borrowing. Thus, non-sovereign issuances accounted for around 85% of the total value of debt issued by Russian residents in 2007.

Table 7 Currency breakdown of total bond issuance by Russian residents

(2001–2007; in percentages)

Currency	2001	2002	2003	2004	2005	2006	2007
US dollar	27.9	55.1	49.3	40.0	46.1	37.2	37.0
Euro	36.6	3.7	7.5	13.2	8.4	10.7	11.6
Other ¹⁾	35.6	41.2	43.2	46.9	45.5	52.1	51.4
<i>Memo: Total volume of bonds issued (USD billions)</i>	2.3	6.3	15.1	31.1	29.8	51.6	60.1

Sources: Bondware and authors' calculations.

Notes: Data refer to domestic and international issuance by both sovereign and non-sovereign issuers. Data refer to flows for the period.

Figures may not add up due to rounding.

1) Mainly Russian roubles.

Table 8 Currency breakdown of loans raised by Russian residents

(2001-2007; in percentages)

Currency	2001	2002	2003	2004	2005	2006	2007
US dollar	77.9	97.3	94.9	93.8	93.1	92.0	87.0
Euro	22.1	1.3	5.1	4.1	5.5	5.2	4.1
Other ¹⁾	-	1.5	-	2.1	1.4	2.8	8.9
<i>Memo: Total volume of loans (USD billions)</i>	2.7	4.1	8.2	7.6	31.4	39.5	75.7

Sources: Loanware and authors' calculations.
Notes: Data refer to flows for the period.
Figures may not add up due to rounding.
1) Japanese yen and other currencies.

Table 9 Currency breakdown of Russian residents' portfolio investment assets issued by non-residents

(2001-2006; in percentages)

Currency	2001	2002	2003	2004	2005	2006
US dollar	93.4	85.4	91.2	92.2	91.6	87.8
Euro	0.4	11.2	6.1	5.4	4.6	6.3
Other ¹⁾	6.2	3.4	2.7	2.4	3.7	5.9
<i>Memo: Total portfolio volume (USD billions)</i>	1.3	2.5	4.4	7.9	17.8	12.2

Sources: International Monetary Fund, Coordinated Portfolio Investment Survey and authors' calculations.
Notes: Equities and debt securities only.
Data refer to stocks at year-end.
Figures may not add up due to rounding.
1) Pound sterling, Swiss franc and other currencies.

Table 10 Currency breakdown of deposits of Russian non-banks held with euro area banks

(2001-2007 (Q3); in percentages)

Currency	2001	2002	2003	2004	2005	2006	2007 (Q3)
US dollar	62.3	54.5	46.2	44.2	49.6	47.9	33.9
Euro	36.9	45.0	53.2	55.2	49.1	51.0	52.8
Other ¹⁾	0.8	0.5	0.6	0.7	1.3	1.1	13.8
<i>Memo: Total volume of deposits (USD billions)</i>	2.1	2.4	2.4	2.6	2.8	3.7	4.8

Sources: Bank for International Settlements and authors' calculations.
Notes: Data refer to stocks at the end of the period.
Figures may not add up due to rounding.
1) Pound sterling, Swiss franc and other currencies.

37.0% of total bonds issued in 2007, while the share of the euro stood at 11.6%.

The role of the euro as a financing currency has been even less pronounced in the international loan market. Loans denominated in euro have only accounted for around 4-5% of total international loans granted to Russian residents in recent years (Table 8). The euro's role as an investment currency has also been limited (Table 9). Available information on

the currency breakdown of Russian residents' portfolio investment abroad suggest that the US dollar has remained the preferred foreign currency of Russian residents holding cross-border assets.

The euro plays a greater role as a currency of denomination for the deposits of Russian non-banks held with euro area banks (Table 10). However, the size of Russian non-bank deposits held with euro area banks is relatively small,

amounting to only USD 4.8 billion at the end of the third quarter of 2007.³²

4.5 SUMMARY

The use of the euro by Russian authorities and residents has increased over the last few years, albeit at an uneven pace. While the role of the euro as an anchor and reserve currency has become significantly more pronounced, in other market segments the US dollar continues to be the dominant international currency. Russian investors, borrowers and traders in international goods and services, as well as foreign exchange, have only slightly increased their use of the euro in international transactions. Against the background of domestic macroeconomic stabilisation, the role of foreign currencies in general has declined. At the same time, there are some signs suggesting that, relative to other foreign currencies, demand for euro cash and euro-denominated deposits has been rising recently.

Three observations may provide some explanation for these trends.

First, the increasing role of the euro in Russian exchange rate policies might largely reflect the approach adopted by the authorities in gradually shifting from an exchange-rate-oriented monetary policy towards an inflation targeting regime, rather than a shift towards the euro per se. By introducing the two currency baskets, the CBR has introduced some exchange rate flexibility without giving up the external nominal anchor which its monetary policy is still based upon, while at the same time preparing for the adoption of inflation targeting in the future.

Second, while the EU is Russia's major trading partner, oil, mainly invoiced in US dollars, continues to be Russia's major export item. This has repercussions for other uses of foreign currency, which may complement the inertia and network effects that characterise developments in the international use of currencies in general. For example, the US dollar may be the preferred currency for international bond issuance,

as liabilities in US dollars are seen as being naturally hedged by US dollar revenues from the oil sector.

Third, against the background of increasing efforts to modernise and open up its financial sector, the Russian authorities are aiming to strengthen the international role of the rouble in a global financial system which is perceived as becoming increasingly based on several key currencies (Financial Times, 2007). Having declared rouble convertibility in July 2006, the long-term goal is now to reduce the use of other currencies in international transactions in favour of the rouble (Putin, 2008), and even to establish it as a reserve currency.³³

³² In the first quarter of 2007 a significant change took place in the currency breakdown of deposits held at euro area banks, as the share of pound sterling-denominated deposits increased from just 0.7% at the end of 2006 to 20.9% at the end of that quarter. This may reflect shifts in the currency composition of the OSF reserve assets to bring them into line with the targeted breakdown (see sub-section 4.3).

³³ See Gilman (2007), referring to a comment by President – at that time First Deputy Prime Minister – Medvedev. President Medvedev confirmed this goal in his speech at the St Petersburg International Economic Forum in June 2008 (BOFIT, 2008b).

5 CONCLUSIONS

In this paper selected aspects of economic relations between the EU and Russia have been reviewed, focusing on the impact of the last two waves of EU enlargement on Russia, as well as the role of the euro in that country. It has been shown that, over the last few years, economic links between Russia and the EU have strengthened considerably in the areas of trade, investment and other financial flows. Strong growth, particularly in Russia, as well as the high price of oil and gas, Russia's major export items, has facilitated this expansion of trade and finance. Moreover, available data do not suggest that EU enlargement has had a negative impact in terms of trade or investment diversion. Thus, the strategic partnership between Russia and the EU has been increasingly underpinned by an expansion of cross-border economic activities. This provides encouragement for plans to set up a "Common Economic Space", i.e. an open and integrated market between the EU and Russia, encompassing almost 600 million people (Padoa-Schioppa, 2005b; European Commission, 2007).

In monetary terms, the euro has gained importance as an anchor and reserve currency in Russia. The CBR's efforts to move to a more flexible managed float, against the background of the medium-term goal to switch to an inflation targeting framework, may explain the euro's more pronounced role in current Russian monetary policy making. In contrast, the US dollar has remained the preferred international currency for investment and financing, as well as for invoicing and foreign exchange trading, given the strong role of the US dollar as an invoicing currency in global oil markets.

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