



Prospects for EU-Russia Relations

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Introduction

Speaking before the postponement of the EU-Russia summit planned for 11 November, EU External Relations Commissioner Chris Patten described EU-Russia relations “a major failure.” Given the rising number of disputes between the two sides it was no great surprise that the Russians decided to postpone the summit (now scheduled for 25 November). Apart from bilateral issues such as the content of the four common spaces, there are increasing concerns about authoritarian trends in Russia, human rights and Russian policy in the former member states of the Soviet Union. In a draft summit declaration about the common neighbourhood Russia deleted EU references to democracy and human rights. There are thus increasing doubts whether the strategic partnership can be based on common values. Furthermore, Member States pay only lip service to the EU’s common strategy towards Russia. President Jacques Chirac, Chancellor Gerard Schröder, British and Italian Prime Ministers Tony Blair and Silvio Berlusconi have all sought to establish close bilateral and personal ties to President Vladimir Putin, sometimes at the expense of agreed EU policy. For example, last year, the Italian Prime Minister, while holding the rotating EU presidency, was not even willing to defend EU policy on Chechnya when hosting President Putin for the six-monthly EU-Russia summit. There will be little possibility of the EU developing a sound policy towards Russia unless EU leaders recognise the importance of speaking with Moscow in one voice. The current tendency simply makes it easy for Moscow to play off one Member State against the other. The result is a weakened EU approach to one of its most important neighbours.

This paper reviews recent political and economic developments in Russia before considering prospects for the future of EU-Russia relations.

The political situation

In the aftermath of the Beslan crisis, there was much speculation about President Putin’s reversion to more authoritarian rule. While there is some evidence that the President is willing to pursue a liberal approach on economic affairs (see below) there are increasing doubts about his commitment to democracy. It would appear that the legacy of the Soviet system and his own KGB background weigh heavily on his approach to politics. The political party system and civil society remain under-developed.

To many observers Russia appears set on a course that turns back many of the democratic reforms that were first initiated during the Gorbachev era. Moreover, if a year ago foreign investors continued to cite corruption and

poor corporate governance as main obstacles to business in Russia, today doubts over Russian political stability are increasingly cited as the greatest concern.

Chechnya is still the most important source of political instability in Russia. Far from bringing a resolution to the conflict, President Putin's heavy-handed response has led to a worsening of the situation and terrorist attacks in Russia have multiplied. The President's response to the worst-ever terrorist hostage-taking in history in Beslan in September 2004 was to re-assert central control over Russian regions. This not only dismantles the local freedoms and autonomy that had been the basis of the Gorbachev reforms, but it is difficult to see how these re-centralising measures will contribute to the fight against terrorism.

Curbs on media freedom, already significant before the Beslan crisis, took on worrying proportions during the hostage siege, with coverage seriously limited or censored at key moments, to the extent that even Russian journalists were tuning in to foreign broadcasts to gain insight into the unfolding tragedy. The resignation of the editor of Izvestia, the day after publishing critical material on the government's handling of the Beslan crisis, as well as the difficulties encountered by two well-known investigative journalists demonstrate continued attempts at silencing the press. There is hardly an independent television channel left in Russia.

The Economy

There is both good news and bad news on the Russian economy. Overall performance for the last year has been positive, and the market remains very strong. A number of the key reforms recommended by the World Bank and the International Monetary Fund (IMF), mainly in the taxation and social spheres are being implemented, and investor confidence remains high despite the Yukos affair.

However significant structural weaknesses remain, particularly the economy's strong dependence on high oil and gas prices and the need for more industrial diversification. The perception that the government is backtracking on some reform promises, persistent fears over ownership rights combined with a significant outflow of domestic capital are raising serious questions about the long term prospects for sustained economic growth. Moreover, as noted above, the political repercussions of the Beslan crisis are highlighting concerns over Russia's drift towards authoritarianism, with potential negative repercussions on investor confidence and the economy as a whole.

In 2003, the upward trend in both international and domestic confidence in the Russian economy was formally confirmed when Moody's, the rating

agency, upgraded Russian government bonds to investment grade status, Baa3. Gross Domestic Product (GDP) growth for 2003 was 7.3%, continuing a trend of steady annual increase since 1998, and the stock market was booming. Foreign domestic investment was also at an all time high: the \$6.5 billion for 2003 represented a 65% increase over 2002. The fact that one of the leading nations in terms of foreign direct investment (FDI) into Russia was Cyprus gave a healthy indication that many Russians were in fact repatriating their offshore assets, a sure sign of confidence in the economy and the system that underpinned it.

In spite of evidence of President Putin's growing authoritarianism, the perceived stability that his policies were bringing has had an overall positive effect on the economy. Indeed, his control over parliament assured the much needed tax reforms that were secured in 2003 and 2004, as well as a complete overhaul of the social benefits system inherited from the Soviet era in 2004. The record is even more impressive if one takes a step back and looks at the overall structural changes in the Russian economy over the past ten years, and sees that there have been more deep changes and fundamental reforms than Western Europe has experienced over the last 100 years.

GDP growth for 2004 is forecast at 6.9% (Russian Ministry of Development and Trade), and FDI continues to grow. The latest official figures point to \$13.5 billion in FDI inflows for this year. A number of high profile deals underpin this foreign investor confidence: Royal Dutch Shell has invested \$1.5 billion in its Sakhalin shelf oil project, the French firm Total Fina Elf has bought 25% of Novatek, one of Russia's fastest growing gas producers, and in October 2004 Conoco Phillips secure a \$2 billion (7% stake) investment in the state run Lukoil.

However, in spite of these impressive figures and positive news on the foreign investment front, some of the economic indicators for 2004 take on a different perspective when viewed in their wider context.

GDP has indeed continued to grow, but slightly less than last year despite the fact that the export prices for Russian oil have grown 20% in 2004. Moreover foreign direct investment, although impressive compared to last year, is due mainly to investments from so-called "real foreigners": i.e. Russians are no longer repatriating assets into Russia, even under the guise of offshore companies. Moreover, capital flight, which had decreased steadily since the post- 1998 stabilisation of the economy, has increased five- fold since 2003: estimates for 2004 are that \$12 billion will leave the country, compared to \$2.3 billion for 2003. The last time foreign investor confidence was paralleled with a similar scale of domestic pessimism was on the eve of the August 1998 financial crisis.

Causes for concern

On the regulatory and macroeconomic front, in spite of the impressive achievements of the past ten years, and more notably during President Putin's first term, significant cause for concern remains. Some of these issues can be viewed as problems to be expected in an economy in transition where reforms are still being implemented. Other areas are more worrying, as they represent not so much an incomplete implementation of reforms, but indicate a potential backtracking or even reversal of reform promises, as much in the economic as in the political spheres. The principal problem areas are the following:

- Insufficient diversification of the economy
- Corruption
- Questions over ownership rights
- Insufficient or inadequate reform implementation
- The political situation

Diversification

Manufacturing growth has outpaced growth in the resource industries for the first time since 2001, with the fastest growing sectors the machine building, chemical and construction sectors. However, all these sectors still remain heavily dependent on the oil and gas industries, where their the main customer base resides. A recent assessment by the World Bank (June 2004 Russia Economic Report) states clearly that diversification in the economy "remains insufficient to cushion the economy against fluctuations in oil prices." This issue alone would perhaps not be sufficient to cast a shadow over the Russia economy. After all in a transition economy with rich natural resources the temptation to use resource revenues to bolster over all economic performance is quite natural. Moreover, the Russia government has created a stabilisation fund thanks to oil and gas revenues, whose long-term aim is to create financial reserves in case of a sharp drop in oil and other commodity prices. However in the wider context mentioned above, there is a real risk today that Russia could follow the path of other resource-rich unreformed economies, whose long term prospects are handicapped by serious structural weaknesses.

Corruption and ownership rights

While foreign investment has grown significantly over the past year, overall figures remain very small compared to other emerging economies, and has the lowest rate per capita in the whole CIS (*source: EBRD*). Much

of this is to be blamed on corruption, whether real or perceived, and an unclear regulatory framework both of which have been identified by foreign investors as the main obstacles to doing business in Russia.

The good news is that President Putin himself has made fighting corruption a priority for his second term, and this fight is one of the main goals of his public administration reform. The jury is still out as to how he will succeed in this task. Unfortunately, corruption and the incomplete or arbitrary application of the rule of law often go hand-in-hand. In this context, the Khodorkovsky/Yukos affair raises some serious questions as to Putin's real desire and ability to tackle corruption in a comprehensive manner.

By far the most worrying issue raised by the Khodorkovsky affair however is that of the security of ownership rights and application of the rule of law. Whichever way the Yukos case is finally resolved, it is hard to see how the psychological fall out can be anything but negative. If, the Yukos affair is to be the first of a series of reconsidered privatisations of the 1990s, it would cast serious doubts over ownership rights proceeding from the whole privatisation program, as most privatisations of the period were conducted with varying degrees of lack of transparency, corruption and backhanded tactics. If, as things stand today, Yukos remains a one-off case, the political motivation behind the hounding of the one person perceived as being capable of mounting a potential credible challenge to President Putin in 2008, will be impossible to ignore. In either case, the message from the Kremlin appears clear: property rights are "secure" so long as you conduct your business on its terms. A reminder of this came again in September 2004 when Yuri Trutnev, resources minister, warned that authorities would be prepared to withdraw production licences from Western and Russian oil companies if deposits are not explored on Moscow's terms. Many analysts interpreted this as a clear threat to BP/TNK for failing to build a pipeline in the Siberian Kovytko oil field.

Insufficient or inadequate reform implementation

Another potential motivation behind the attack on Yukos could be the Russian government's desire to secure tight control over the strategically important oil and gas sectors. Indeed, with the EU largely dependent on Russian gas, and fast-growing demand for Russian oil coming from China and India, the energy sector is becoming an essential tool with which Russia is able to project its power abroad.

Recent events indicate that the government is keen to ensure its control of this tool. In September 2004 the merger of the state oil company, Rosneft, with Gasprom, gave the state a controlling stake over Gasprom, and by extension, significant control over the whole oil and gas sector. The

dismantling of Yukos and persistent rumours about the imminent sale at a ridiculously low price of its subsidiary, Yuganskneftegas, to the most likely buyer, Gazprom, seem to be confirming analysts' apprehensions that we are witnessing the creation of a state monopoly over the whole energy sector.

If this does indeed happen, it would go against both the recommendations of the World Bank, which insists that the reform and scaling down of state monopolies is a prerequisite for sustained economic development in Russia, as well as statements by the Russian government itself earlier this year, when the Economy Minister, German Gref, confirmed that one of the government's key goals was to ensure diversification of ownership and a move away from state control in the oil and gas sectors.

The discontinuity between reform promises, rhetoric and actual actions in the energy sectors is being echoed in other parts of the economy as well. In the banking sector, following the May 2004 banking crisis, we are witnessing a consolidation of the state sector to the detriment of smaller privately owned institutions. All in all there is less transparency and competition in the banking sector now than a year ago. Set against statements by President Putin in April 2004 when he called for more diversification, transparency and reform in the banking sector and insisted that "the non-market sector should be reduced as much as possible" the disparity between statements and reality came across yet again. Interestingly, banking analysts all concur that there were no objective reasons to precipitate the spring crisis, and that triggering factors were psychological, linked to depositors' fears that the government would withdraw licences and freeze deposits arbitrarily. This again highlights the problems linked to unclear ownership rights in Russia, and the perception of arbitrary actions by the government, perceptions which recent actions by the government are only exacerbating.

The latest reforms, much called for by the World Bank, and the IMF, and commended by many analysts, are the monetisation of state benefits, mainly in the health and pension spheres. These reforms were passed by the Duma in the summer of 2004, against the backdrop of widespread popular opposition. The fact that they were proposed at all, let alone passed, can be seen as evidence of the Putin government's liberal economic credentials, and the determination with which it is prepared to tackle one of the most entrenched inheritances from the Soviet period, which, if left unsolved, would remain a serious obstacle to the long term creation of a liberal market economy. For this, most financial institutions and western economists, have, rightly, strongly commended President Putin.

However, it is important to note in the context of the President's stated desire to reform the health sector that— according to the World Health

Organisation— Russia has the fastest growing HIV-AIDS infection rate in the world. President Putin has still failed to address the issue seriously in any public statement, vastly insufficient funds are being put aside to combat the disease, and there is no determined government financed nation-wide information campaign on HIV prevention. The government reaction to the current health crisis begs the following question: in his impressive reform effort, is Putin really intent on addressing the crucial issues that will ensure Russia's long term economic prosperity, or is he mainly intent on being seen to be playing the part wished upon him by Western governments, while keeping a lid on an issue which will have far reaching consequences on the long term development of the Russian economy? A recent study by the World Bank on the economic consequences of HIV-AIDS suggests that in the most optimistic scenario, taking into account current infection rates but supposing a dramatic increase in public spending on AIDS, the epidemic will adversely effect GDP growth by -1.17% by 2010. A more pessimistic scenario, in which the government maintains its spending and actions at today's levels, predicts that HIV-AIDS will cause a 9.5% drop in Russian GDP by 2010. Unless the issue is addressed seriously by the Russian government soon, the looming health crisis in Russia will undermine not only any subsequent further reform efforts, but the very fabric upon which a stable economy and political system can be built: i.e. the population of a nation.

Russia and the EU

Institutional Framework

The legal basis for EU relations with Russia is the Partnership and Cooperation Agreement (PCA) that came into force in December 1997 for an initial period of ten years. It establishes the institutional framework for bilateral relations, sets the principal common objectives, and calls for activities and dialogue in a number of policy areas. It covers:

Trade and economic cooperation : liberalisation of trade based on most-favoured-nation (MFN) treatment and the elimination of quantitative restrictions; legislative harmonisation; and provision on the establishment and operation of companies, services, current payments and the movement of capital, competition and intellectual property.

Co-operation in science & technology, energy, environment, transport, space and a range of other civil sectors.

Political dialogue: on international issues, democracy and human rights.

Justice and Home Affairs: Co-operation to prevent illegal activities, trafficking in drugs, money laundering and organised crime. An Action Plan on combating organised crime was signed in June 2000.

A protocol was signed by the EU and Russia on 27 April 2004 to extend the PCA to the 10 new Member States as of 1 May 2004. Russia has found it difficult to come to terms with the fact that eight former communist countries, including three former Soviet republics, have joined the EU. While Moscow has tended to ignore its former satellites in central Europe, it has continued to press the Baltic states for alleged maltreatment of the ethnic Russians living there. It has never paused to consider how these Russians were moved there by Stalin and that none of them wish to go and live in Russia itself. For several years Russia has refused to sign and ratify the border agreements that were agreed with Estonia and Latvia, partly using the issue as a hammer to beat the Baltic states. Partly as a result, some of the new Member States have pushed the EU to adopt a tougher approach towards Russia.

Russia was also the subject of a 1999 EU *common strategy* that was supposed to inject greater coherence between the EU and Member States in their policies towards Russia. Most observers agree that it has been a failure. Some EU Member States have been unwilling to align their bilateral agendas and programmes with those of the EU.

In terms of financial and technical assistance, more than €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 reinforcing democracy and the rule of law. Partly due to bureaucratic problems on both sides, however, Tacis has had a limited impact.

Other major sources of assistance are the European Initiative for Democracy and Human Rights and the European Commission Humanitarian Office (ECHO) which is the most important donor active in the North Caucasus. In addition, the EU provides financial assistance for non-proliferation and disarmament projects.

Steel and textiles are the main industry sectors covered by bilateral trade agreements. The Energy Charter Treaty has been awaiting ratification by the Duma for a long time. Recent progress has been made, however, with regard to Russian ratification of the Kyoto protocol.

Bilateral institutional contacts are to a large extent determined by the PCA. They include two summits each year, a Permanent Partnership Council (ministerial level) and a Cooperation Committee (senior official level). In addition, nine sub-committees (working level) deal with technical issues. There is also a regular ministerial and official dialogue on foreign and

security policy issues. A Parliamentary Cooperation Committee has also been established, where members of the European Parliament and the Russian Duma meet on a regular basis.

The Four Common Spaces

Partly in recognition of the limitations of the PCA, both sides agreed at the St Petersburg summit in May 2003 to start working on four 'common spaces.' It was decided to create a common economic space; a common space of freedom, security and justice; a space of co-operation in the field of external security; as well as a space of research and education, including cultural aspects.

As far as the common economic space is concerned, the priority issues were identified as the energy dialogue, transport, the environment and steps to improve the investment climate and pursue regulatory convergence. Preparations for Russia to join the WTO were also emphasised.

Regarding the common space of freedom, security and justice, the priorities were to be border management and migration issues. The EU was unable to agree to Russian demands for visa-free travel but did agree to setting up a working party to examine the issues including the better use of existing flexibilities under the Schengen Agreement.

Both sides also stressed the importance of working together in crisis management, and welcomed practical co-operation in the field of European Security and Defence Policy. Russia has participated in NATO/ESDP missions in the Balkans.

The Rome Summit in November 2003 endorsed the concept of the common European economic space. On 9 February 2004, the Commission adopted a Communication on Russia underlining that the EU and Russia should be ready, as strategic partners, to discuss frankly all issues of concern, including human rights, media freedom and events in Chechnya in addition to strengthening co-operation on common interests.

One of the most difficult issues for the EU and Russia to resolve was transit to the Kaliningrad oblast. A relic of the Second World War, Kaliningrad suffered severe socio-economic problems as a result of the break-up of the Soviet Union. After lengthy negotiations a specific transit regime, based on facilitated travel documents, came into effect in July 2003. The EU has also offered substantial financial assistance to support the socio-economic development of Kaliningrad.

The most sensitive issue, however, remains the situation in Chechnya. The EU, while condemning terrorism in all its forms has called for a peaceful and durable solution to the current conflict, based on the territorial integrity of Russia, the creation of representative institutions and respect for human rights. The assassination of Chechen President Akhmad Kadyrov in a terrorist attack on 9 May 2004, bombings in Moscow, two planes blown up and the terrible school siege in Beslan has demonstrated the seriousness of the situation. Russia was stung by Dutch Foreign Minister Ben Bot's suggestion following the Beslan crisis that the EU might be able to help if the full facts were known. Moscow's response was that this was an "internal affair" despite the fact that it had loudly proclaimed the attack was carried out by "international terrorists."

The EU has called on Russia to cooperate with UN rapporteurs, the Council of Europe and the OSCE, to promote stability, transparency and the rule of law. It calls on Russian authorities to thoroughly investigate all claims of human rights abuses and to prosecute those found responsible. The EU, as the largest donor of emergency aid, remains concerned about the humanitarian situation, at the low level of access to Chechnya for aid providers, at the treatment of internally displaced persons and at the modest pace of reconstruction in the region.

Outlook

The future bilateral agenda will likely continue to be clouded by Chechnya and the authoritarian trends in Russia. At the same time the EU is aware that Russia is a vital partner in terms of energy supply (mainly natural gas) and in resolving some sensitive international situations, ranging from the Middle East to Moldova. On the practical front, the focus is likely to be on the establishment of the four common spaces. There have been disputes between Member States regarding the way forward with the common spaces but EU foreign ministers agreed on 2 November that there would have to be a comprehensive package that was "balanced and substantial." This meant a rejection of the Russian proposal to sign separate agreements when a consensus had been reached. In addition there are growing concerns about Russian aims in Ukraine, Moldova and Georgia. Moscow has rejected proposals for a joint EU-Russian approach to some of the trouble spots in Transdniestria and Abkhazia. Russia, in contrast, is seeking greater involvement in European Security and Defence Policy (ESDP) on institutional arrangements that the EU finds unacceptable. There are also differences on establishing a regular dialogue on human and minority rights, on energy pricing and on overflight rights over Siberia.

On the positive side, an improved dispute settlement procedure for the PCA was adopted in April 2004. There are also on-going negotiations on

trade in nuclear materials, fisheries, satellite navigation (Galileo) veterinary cooperation and a Readmission Agreement.

Conclusion

The Beslan crisis, the media censorship during and after, and its political repercussions in Russia, have shattered the illusions of many of the most stubbornly optimistic Russia analysts that Russia was moving towards becoming what the Russians like to call “normal country,” or non-Russians would like to call a country which is on the whole predictable for its foreign and domestic interlocutors. Far from being seen as tackling the greatest challenge to his power with effective measures, President Putin’s response has been to reinforce central control with no perceived benefit for the fundamental crisis at play in Chechnya.

In the economic sphere, a failure to contend with the structural economic weaknesses highlighted in this paper risks leading Russia down the path of Suharto’s Indonesia or Saudi Arabia, where reliance on natural monopolies have created a concentration of wealth, and exacerbated inequalities and protection for state sponsored inefficient industries overly dependent on commodity price cycles.

In the decade since the collapse of the USSR, Russia’s response to Western criticism of its reforms, or lack of, has been to take refuge in the old adage of “we are different, you do not understand us.” This is no longer acceptable rhetoric from a country, which seeks to be treated as an equal in the privileged club of like-minded nations, be it in the G-8, the World Trade Organisation (WTO), in the coalition against terrorism, or as a strong reliable partner of the EU. In its relations with Russia, Europe has the right to insist that democratic principles are to be upheld by a nation which wants closer integration with the European Union. If these principles are not upheld the EU must stop being afraid of taking tough stances against Russia when the principles it purports to defend are overridden. In the long run, Russia has much more to lose from the EU’s refusal to cooperate with it, than vice-versa.

There should be no difference between the aims of the EU and its Member States towards Russia. Both the EU’s High Representative for CFSP, Javier Solana and Commissioner Chris Patten have underlined the EU’s objectives as fostering political and economic stability in Russia; strengthening the rule of law; promoting a better investment climate and cooperating where possible in the fields of CFSP/ESDP, justice and home affairs, environment and nuclear safety.

Russia has shown that it takes the EU seriously when it is confronted with a united voice. For example, it basically had to accept EU proposals for

transit between the Russian main land and Kaliningrad. The EU will need to remain firm and united in the future if it is to develop its strategic partnership with Russia according to its own democratic principles and values.

Although some progress has been made in EU-Russia relations there remains considerable mutual distrust, partly through ignorance of each side's motives. What is needed is a frank dialogue covering all sensitive issues including values, multilateralism and minority rights. Moldova and Belarus should be on the agenda as well as the worsening situation in the Caucasus. Russia is still driven by a great-power mentality that tends to view developments as a zero-sum game. It will be important to engage with the coming generation of Russian leaders to explain the importance of 'soft power' in international relations. The EU needs to do more to attract Russian students and facilitate travel for genuine business and tourist travellers. For its part, Moscow should accept the EU as a serious negotiating partner and not try and undermine it by seeking special deals with Member States or by-passing PCA structures. Both sides are condemned to live with each other and will increasingly rub up against one another as a result of EU enlargement. A genuine strategic partnership can be developed only if there is acceptance of common values and these values are adhered to by both sides.

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