

Summary: Some observers in Europe think that Russia's economic downturn and President Dmitry Medvedev's critical assessment of his own country's situation will make Russia more humble and appreciative of EU offers of cooperation. The European Union is getting ready to launch a "modernization partnership" with Russia.

However, any strategy that is predicated on positive change within today's Russia carries a big risk of failure. Vested interests and weak democratic institutions have left the Putin regime inflexible. The European Union needs to be prepared to deal with a Russia that is often stubborn and defensive. Energy and climate change offer scope for positive cooperation but the European Union needs to be prepared for continuing tensions over the common neighborhood and international issues, such as Iran's nuclear program.

Can and should the EU and Russia reset their relationship?

by Katinka Barysch¹

Jose Manuel Barroso described the November 2009 EU-Russia summit in Stockholm as "one of the best meetings we have had." Nothing much was decided at the meeting. EU leaders and officials were simply glad that relations appeared back to "normal" following two low-points with Russia: the August 2008 Russia-Georgia War and the Russia-Ukraine energy dispute in January 2009.

That "normal," however, was already a state of paralysis, accompanied by disillusionment on both sides. Having once hoped for a strategic partnership, free trade, an energy union, and constructive cooperation across the European continent, the EU today expects little of Russia. The Europeans are glad that their internal divisions over Russia are shallower than they have been in recent years. Poland and Lithuania no longer block the EU's Russia policy to draw attention to Russian bullying. Countries like the United Kingdom and Sweden that formerly had tensions with Russia have improved bilateral relations. The European Union is better able to speak with one voice to Russia. But it is not clear what the message should be. Devoid of a coherent strategy, the most EU policymakers seem to hope for is to avoid another crisis.

Stale and stagnant

"When was the last time we decided anything of substance [at an EU-Russia summit]," shrugs one EU official. Another lists the meagre achievements of the summit as signs that there is still life in EU-Russia relations: the EU and Russia agreed on an early warning mechanism designed to facilitate the management of future energy crises; they put some money into cross-border cooperation programs; and Russia used its meeting with the EU to announce targets for cutting carbon emissions ahead of the Copenhagen climate change summit.

One the whole, however, the EU-Russia relationship is stagnating. Talks on a new Partnership and Cooperation Agreement (PCA) are in their seventh round, without having produced any substantive agreement on the areas that matter most: trade and energy. That is no surprise. The Russian leadership is prevaricating on whether Russia should finally join the World Trade Organization (WTO) or first build a customs union with Belarus and Kazakhstan. Before there is movement toward the WTO, EU-Russia trade talks are focusing on limiting the damage from Russia's occasional erratic tariff hikes. On energy, there is plenty to talk about (see below). But EU hopes that PCA clauses would be based on the principles of the

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Energy Charter Treaty were dashed in 2009, when Russia withdrew its signature from the treaty that it had hitherto refused to ratify.

Of the many technical committees foreseen in the old PCA, only one (on customs) has met in the last five years. In its human rights dialogue with Russia, the European Union has encountered “zero openness,” in the words of one official involved. The project to integrate the European Union and Russia across four “common spaces” (economics and energy, foreign and security policy, internal security and justice, and education and culture) has produced little more than anodyne reports. Although Russian President Dmitry Medvedev recently admitted that some EU laws were of top quality, Russia remains allergic to the idea that it should unilaterally take over EU rules and regulations. For the European Union, the idea of “converging” toward Russian standards is equally unappealing. Hence integration efforts have gone nowhere.

Some leaders in the European Union will be tempted to devise yet another re-launch of EU-Russia relations. One EU diplomat said he was surprised that there had not been more “reset envy” in European capitals after the Obama administration declared that it wanted a new start in its relationship with Russia. The Zapatero government in Spain, which holds the EU presidency in the first half of 2010, has made a new accord with Russia a priority. Brussels insiders suspect that Russia-friendly politicians in Berlin, Rome, and Paris are itching to come up with some big new initiative. But what?

The U.S. “reset” is about a new arms control agreement and getting Russian support for Western policy in Iran, Afghanistan, and other trouble spots. Washington can be hard-nosed, focused, and strategic in its relationship with Moscow. International issues are obviously an important part of the EU-Russia relationship as well, in particular Russia’s unwillingness to back tougher sanctions on Iran. The European Union, however, has a much more complex relationship with Russia, which makes strategic trade-offs a lot trickier.

Some in the European Union are still hoping to find a mechanism that will create enough trust, interdependence, and convergence with Russia to allow for mutually beneficial cooperation across all areas. In the corridors of Brussels, plans for a “modernization partnership” are once again being talked about. Germany’s former foreign minister, Frank-Walter Steinmeier, used the term frequently in 2007-2008 to offer German help for Russian reforms in healthcare, science, or public adminis-

tration. Germany’s industrialists, many of whom have sizeable stakes in the Russian economy, cheered the idea. France—never far behind when it comes to doing bilateral deals with Russia—launched its own modernization partnership with Russia in November 2009. Since French business is less engaged in Russia, the agreement focused on energy deals and the sale of French warships to Russia—much to the chagrin of people in the Baltics and other East Europeans wary of Russian intentions.

A modernization partnership?

EU officials have been talking about a possible EU-Russia modernization partnership since 2008. Although they have not gone into detail, the basic idea seems to be that the European Union would assist Russia in its reform efforts by providing capital, technology, and skills. The underlying assumption is that a more “modern” Russia would be more Western-oriented, open, and easier to deal with. Russia showed little interest in such overtures from the European Union while it was still enjoying an oil-fueled economic boom and foreign money was flowing in.

In 2008, Russia’s economic luck turned. The country was hit harder by the global economic crisis of 2008-2009 than any other large emerging market country. It suffered not only from a domestic financial freeze and a drying up of much-needed foreign capital, but also from the collapse in oil prices. In 2009, Russian GDP fell by 8 percent while foreign direct investment nearly halved. A big budget surplus has turned into a gaping hole. The previously awe-inspiring piles of foreign exchange reserves and sovereign funds have dwindled. With oil prices seemingly stuck at \$70 a barrel (and gas and metals prices also depressed), replenishing these reserves will take a long time. Economists inside and outside Russia say that the country must take lower commodity prices as an opportunity to finally diversify the economy away from oil, gas, and other basic commodities.

President Medvedev seems to concur. In 2009, he launched several volleys of stinging criticism about the state of his country: the over-dependence on oil and gas exports, the ubiquitous corruption, the stifling bureaucracy, and the oligarchs making a quick buck without building sustainable businesses. The solution, Medvedev said, was modernization, liberalization, the rule of law, and more personal freedom.

For some Europeans, the weak state of the Russian economy, together with the outbreak of self-flagellation at the top, represents an opportunity. In a survey published by the EU-Russia Centre in January 2010, 81 percent of the Russian foreign policy

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experts and lawmakers polled said that Russia could not modernise without foreign help. As Russia's biggest trading partner and investor, the European Union is superbly suited to help Russia embark on the kind of economic revolution that Medvedev seems to have in mind.

It would, therefore, be only natural for the European Union to re-brand its relationship with Russia once more: the objective of a "strategic partnership based on common values" has alienated Russia rather than drawn it closer to the European Union. Why not replace it with a more pragmatic modernization partnership based on common interests? The European Union obviously has a big stake in the success of Russia's modernization efforts. But there are risks involved in the European Union trying to re-launch its Russia policy based on a concept that is, upon closer inspection, problematic.

First, the transfer of more EU money, technology, or know-how may help Russia to modernize but it may not result in any kind of partnership. Many Russians think that the financial and economic crisis has discredited the Western model of capitalism and that Russia should look more toward China, Korea, and other fast-growing emerging markets for clues about how to increase its income levels. While links to the West remain obviously important, Fyodor Lukyanov, a Russian foreign policy analyst, argues that Russia's foreign policy recently went through a "paradigm shift." Since Mikhail Gorbachev, Russian foreign policy was underpinned by the idea that Russia was destined to join the European mainstream and integrate into Western institutions. Russian Prime Minister Vladimir Putin, during his presidency, sought to change the process by which this would happen—more convergence, less unilateral adjustment—but the basic idea remained valid. Today, neither Putin nor Medvedev talk about integration. Medvedev has admitted that Russia would benefit from Western help with its modernization efforts. But, says Lukyanov, Russians see the EU as a reservoir of money, skills, and technology; not as a model on which Russia will ultimately converge. If the European Union was serious about helping Russia to reform, the result could be a Russia that is stronger, but not necessarily easier to deal with.

The Breshnevization of Putin's Russia

Second, a genuine modernization alliance would have to be bottom-up and driven by the private sector. The Russian leadership is pursuing a model of modernization that is state-centric and top-down. It throws money at new institutes to foster research, it nationalizes big industries, tells state-owned banks which sectors

to lend to. It does not do the things that would be required for genuine economic diversification: foster entrepreneurship and innovation, reduce corruption, invest in a modern education system, cut red tape, reign in monopolies, shake up the court system, and liberalize finance.

EU companies have invested billions in the Russian economy. However, total foreign direct investment (FDI) is far too low to have the kind of transformative impact it had on say, Hungary (Russia's stock of FDI is 20 percent of GDP, Hungary's is 180 percent). While Russia broadly welcomes foreign money and technology, the 2008 law on foreign investment puts tight restrictions on foreign ownership in 42 strategic sectors. As long as Russia's business environment remains difficult and unpredictable, there is little the European Union can do to coax private companies to channel more money and technology eastward.

Sending Western executives and engineers to Russia is becoming harder, not easier, due to Moscow's tough visa and work permit restrictions. European scientists are unlikely to flock to a country that cannot even hold on to its own researchers (who are emigrating on mass). In short, unless Russia is really ready to reform, any modernization partnership would be limited a few government (or EU) led programs. Such programs in say, science or industrial policy would be useful. But they would hardly be enough to help transform the Russian economy or give momentum to EU-Russia relations. If there was political will to drive such projects forward, the European Union and Russia could do so easily in the framework of the PCA and four common spaces.

The idea of a modernization partnership suffers from the same challenge as previous attempts to build a functioning relationship with Russia: its success is predicated on positive change within Russia. There is no doubt that Russia has changed tremendously since the 1990s, but not necessarily in the way that the European Union and its capitals had wished for. And it is not clear that today's Russian leadership can, or wants to, move toward more open markets, the rule of law, and more personal freedom. While President Medvedev talks about the need for open markets and entrepreneurial freedoms, Putin (who most experts assume really calls the shots) is talking about "Russian conservatism" and the need for state control of the economy.

Many in the West may be encouraged by Medvedev's frankness about his country's weaknesses. But Russia's liberals are downbeat: Medvedev, the (notionally) most powerful person in the country is warning that Russia is going to the dogs unless radical reforms start soon; yet nothing happens. Vested inter-

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ests are deeply engrained. The economic crisis may have cost many oligarchs their fortunes but it has increased the business stakes of well-connected bureaucrats even further. The middle class—usually the first ones to lobby for better property rights and more personal freedom—is apathetic. Too many owe their relative comfort to state employment or handouts. Since Russia’s democratic institutions function badly, the whole system is precariously balanced on the whims of Putin and his small circle.

The European Union can and should remind the Russians that their economic model is unsustainable. It should make clear demands for improvements in the business environment that would benefit European and Russian companies alike. But just like the Soviet Union in the 1970s, the Putin regime might already be too rigid to allow for the changes necessary to guarantee economic diversification, modernization, and sustainable growth. Some analysts are now talking of the “Breshnevisation” of Putin’s Russia.

A Russia that is inflexible and brittle will remain an awkward partner for the European Union. If leaders consider internal change too risky, they may find it easier to blame others for Russia’s predicament and block international initiatives to show their strength.

Threat to the energy super-power

While the prospects for an overall “reset” of EU-Russia relations look meagre at the moment, there is scope for constructive cooperation in energy and climate change. Before the onset of the economic crisis, the European Union bought about one-quarter of its total gas needs from Russia (now it is somewhat less). For Russia, the EU remains by far the biggest and most lucrative market for its oil and gas, with 90 of energy exports heading westward.

Yet the energy relationship between the two has been beset by problems. The initial idea of the EU-Russia energy dialogue, launched in 2000, was that Russia would liberalize its oil and gas sector while the European Union would help with money and expertise. When Putin became president, he quickly realized the strategic (and economic) value of controlling the world’s biggest gas company and longest pipeline network. Instead of breaking up Gazprom, the state re-acquired majority control and encouraged the gas giant to snap up refineries, pipelines, and distribution rights across Europe. During the years when oil and gas prices rose steeply and continuously, Russia felt in a strong position to set the terms of its energy relationship with EU countries.

However, in 2008 oil prices collapsed, and gas prices followed with a lag. In 2009, European gas demand fell for the first time ever. Although oil prices have recovered to some extent, the sluggish global recovery will cap energy demand going forward. New technology allows the commercial exploitation of massive amounts of “unconventional” gas (gas coming from rock formations) in the United States, and probably soon in Asia and Europe too. Already, additional supplies have depressed prices in the spot market for short-term gas contracts. European companies have tried to wiggle out of their more expensive long-term contracts for piped gas from Russia and Algeria.

The EU’s climate change targets and its emerging diversification policies are adding to Gazprom’s uncertain outlook. If the European Union is to achieve both its target to increase energy efficiency (by 20 percent by 2020) and boost the share of renewables to 20 percent, the role of gas in the energy mix will have to shrink. The Europeans are also debating how to diversify their gas supplies away from Russia. Many in Europe ridicule the EU-backed Nabucco pipeline through Turkey and the Balkans as a pipe dream. But Gazprom has taken it sufficiently seriously to push ahead with its €20 billion South Stream pipeline that would compete with Nabucco for both Caspian gas reserves and South East Europe’s fast-growing energy markets.

Pipeline competition, disputes over long-term contracts and uncertainty over both supply and demand make for an antagonistic energy relationship. Neither the European Union nor Russia can want this.

Climate change and energy efficiency

Against the backdrop of heightened uncertainty in global energy markets, Russia may become a more forthcoming negotiating partner in energy. If the EU offers security of supply (meaning that the big European energy companies stick to long-term contracts with some sort of predictable pricing formula), Russia may compromise in other areas. There is plenty to talk about. The European Union and Russia may want to discuss how Russian gas may one day flow through Nabucco and so obviate the need for the expensive and politically divisive South Stream pipeline. Russia will need Western capital and know-how to develop difficult new gas fields. The European Union still wants Russia to accept joint principles on energy sector investment and transit.

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While negotiations over gas will probably remain tricky, the European Union and Russia should increase the climate change component of their energy relations. Russia is the world's fourth biggest emitter of CO₂ (if the EU is taken as a bloc) but it has so far shown scant interest in joining the global fight against climate change. Russia's economy remains one of the most energy inefficient in the world (it takes three times as much energy to produce a unit of GDP in Russia as in the EU). Russia is planning to use more coal, not less, for heating in the future. Just 1 percent of Russia's energy output comes from renewables but experts say this could rise to 30 percent if the country started building dams, solar panels, wind turbines, and geothermal power stations.

Some Russians may welcome the prospect of warmer weather. But the World Bank and other research outfits predict that Russia is, in fact, exceptionally vulnerable to the threats of climate change. Thawing permafrost could turn vast landscapes into unmanageable swamps. A population largely living in shoddy, Soviet-era housing would suffer a lot if floods, storms, and heat-waves became more frequent.

Although Russia belatedly declared that it would aim to cut its CO₂ emissions by 10-15 by 2020, from 1990s levels, that target is not terribly ambitious. Russia's carbon emissions fell steeply in the 1990s when much of its Soviet-era industry collapsed. They are now on the rise and Russia can allow them to do so and still meet its 2020 target. Existing government plans for energy savings and higher gas prices have been put on ice during the current economic crisis. If Russia managed to make progress on energy efficiency, it would not only help the world's climate but also encourage its industries to become more competitive and it would free up more gas for sale in more profitable markets abroad.

The European Union and Russia agreed to work together on energy efficiency in 2006. But a joint task force on energy efficiency has met only a few times since then and a limited number of pilot projects will not have a big impact. Clearly there is ample room for cooperation in this area, as well as in setting up the mechanisms needed to curb carbon emissions. Russia does not have the means at the moment to monitor and restrict emissions from individual factories or power plants. The European Union—which has much experience in these matters—can help Russia to build up the infrastructure and expertise so that one day it will be able to join an emissions trading scheme.

The EU-Russia energy relationship would probably be more cordial if it was less exclusively focused on pipelines and mutual market access and more on cooperation on climate change and energy

efficiency. The European Union—which is struggling to reclaim its leadership on global climate change after being painfully sidelined in Copenhagen—should make it a priority to help Russia become greener. Such cooperation should in theory be free from the ideological battles that stymie other joint economic projects.

However, even if the European Union and Russia manage to forge a smoother energy and climate change partnership, it is unlikely that this will create enough goodwill on both sides to prevent disagreements in other areas. The most contentious issue in EU-Russia relations will remain the fate of the countries that lie between the European Union and Russia, in what the EU's calls the common neighborhood.

Tensions in the neighborhood

Russia initially watched with unease as the EU took in ten Central and East European countries and sought to draw non-candidate countries closer through its European Neighborhood Policy (ENP). Moscow then relaxed as it realized that the ENP was of little discernable impact and that even EU membership did not prevent it from doing good business and building political links in countries such as Bulgaria or Slovakia.

Nevertheless, the EU's Eastern Partnership (EaP) Initiative, launched in May 2009, met with an angry frown in Moscow. The EaP foresees deeper integration and reinforced cooperation with six countries in Eastern Europe and the Caucasus beyond what is on offer to the EU's Mediterranean neighbors. It is not that the Kremlin has suddenly developed more respect for the EU's ability to act. The EaP suffers from some of the same flaws as the ENP in terms of not providing enough incentives to entice Ukraine, Moldova, and the other countries included to change.

But the initiative was launched at a time when Russia's own neighborhood policy was in deep trouble. In the aftermath of the August 2008 Russia-Georgia War, even Russia's staunchest allies sought to hedge their bets by diversifying their foreign policies. Armenia started talking to Turkey. Turkmenistan reinforced its energy ties with China and made encouraging noises about selling gas to the European Union. Belarus—previously barred from joining EU programs because of its shoddy human rights record—did just enough to be allowed to join the EaP. Not a single former Soviet country followed Moscow in recognizing Abkhazia and South Ossetia.

Moreover, now that NATO accession for Georgia and Ukraine

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is no longer a near- (or even medium-) term prospect and the United States has scrapped its missile defence plans for the Czech Republic and Poland, it appears that more of Russia's zero-sum thinking about the common neighborhood is focused on EU plans. The EaP could give the neighbors more options and thus make it harder for Russia to keep them in its "privileged sphere of influence," as Medvedev likes to call Russia's post-Soviet neighbors.

EU politicians and officials like to stress that the EaP is in the "common interest" of the European Union and Russia. They argue that Russia should want a stable, prosperous, and secure neighborhood just as much as the Europeans and the neighbors themselves. Alas, few Russians see it this way. Russian foreign policymakers know that a resolution of the region's "frozen conflicts," well-functioning governments and brisk economic growth would make it much harder for Russia to meddle with the countries in the neighborhood or bully them. Therefore, the EU's idea to make the EaP more palatable to Moscow by inviting it to join region-wide cooperation projects has made little headway. That is Russia's loss. The EU needs to stand firm and be prepared for tensions over the common neighborhood. It should reinforce the EaP and communicate to Russia in private that there are "red lines" over Moscow's meddling in former Soviet countries or seeking to undermine their sovereignty.

A comprehensive view of European security

For the same reason, the European Union was right to react to Russian proposals for a new "European security architecture" with caution. Some West European policymakers have expressed sympathy with Russian complaints that it feels sidelined, even threatened, in an EU and NATO-dominated European space. But most Europeans read the proposals put forward by Medvedev and other Russian politicians as an attempt to drive a wedge between the Europeans and the United States and to give Russia a *droit de regard* in its neighborhood. For the EU member states this is a non-starter.

Russia's main problem with the current European security structure is not the European Union, but an expanding NATO. Nevertheless, the European Union could not entirely ignore Medvedev's overtures. EU officials have stressed that Russia's almost exclusive focus on hard security does not mesh with the EU's own notion that stresses not only new threats such as cyber-crime and terrorism, but also highlights the economic and human rights dimension of security. The European Union also insists that the Organization for Security and Co-operation in

Europe (OSCE) is the best venue to discuss such issues, and that although a binding treaty may well be one of the outcomes of an ongoing debate about security, it should not be the starting point.

A partnership of necessity

EU-Russia relations are back to "business as usual" following the suspension of PCA negotiations after the Russian-Georgia War. The Russians have enough problems to deal with so they welcome smooth relations with the European Union. The EU member states are more united on Russia than they have been in years, but that has partly to do with the fact that there are no big, contentious issues on the EU-Russia agenda. Business as usual between the European Union and Russia has become a grinding process of moving toward economic integration, a functioning energy partnership and a better political understanding. Progress has been frustratingly slow. Some EU politicians may be tempted to re-launch or reset EU-Russia relation once again by giving it a flashy new name, such as a modernization partnership. They should resist. On the contrary, the European Union should concede that its initial ambitions for its relationship with Russia have not materialized and that the slow pace of internal change in Russia limits what can be achieved in bilateral relations. The reality is that EU-Russia relations have more potential for improvement in some areas (energy, climate change) than in others (the common neighborhood). There is no magic formula that can change that.

The European Union should continue pursuing its PCA negotiations with Russia, but not at any price. The main ingredients for the new treaty are energy and trade. Only once Russia has joined the WTO does it make sense for the European Union to offer deeper EU-Russia trade integration. It needs that carrot of better market access to entice Russia to accept the more liberal principles on energy investment, trade, and transit that the Europeans want to see in the new treaty. Meanwhile, there is a lot the EU and Russia can do to fill the idea of the four common spaces with some substance—provided the political will exists.

EU-Russia relations are unlikely to take a big leap forward in the near future. The European Union should acknowledge that fact and reduce the number of summits it holds with Russia from two to one a year. Having a summit every six months puts pressure on politicians and officials to come up with deliverables. The EU-Russia relationship is already littered with plans, forums, and dialogues that work badly or not at all. It does not need any new initiatives.

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The European Union should also tone down its rhetoric on strategic partnership and put more effort into transmitting a clear and consistent message to Russia. The message should be that the EU stands ready to move forward on deeper integration and more extensive co-operation with Russia. But it wants to see progress on economic reform as well as human rights and political freedoms.

The European Union's strongest stance must be reserved to questions regarding the common neighborhood. The European Union cannot and will not accept any Russian claims to a sphere of influence. The countries in that region have the right to define their own destiny. While being firm on this point, the European Union must, however, be careful not to adopt the kind of zero-sum approach that many Russian policymakers display.

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About the Trilateral Strategy Group

The Trilateral Strategy Group is a core convening activity of GMF's Mediterranean Policy Program, and is conducted in partnership with TUSIAD (the Turkish Businessmen's and Industrialists' Association), Koç Holding, and the Swedish Ministry of Foreign Affairs. The group meets roughly twice each year, and brings together policymakers, experts, and opinion shapers from Turkey, Europe, and the United States to discuss a changing menu of strategic topics in "trilateral" perspective.

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