# RUSSIA AND THE EUROPEAN UNION

By Hugh BARNES

**Once just a bridge within the Soviet Union today it connects Russia to Estonia. Here is where the EU ends. Here is where NATO ends. Here is where the West and the East are divided. On the left is the Estonian fortress on the right the Russian. Both serving as a cold reminder.**

**Russia's war in Georgia last summer, and its unilateral recognition of South Ossetia and Abkhazia, led to a great deal of handwringing in European Union circles. Many politicians sided with the Georgian leader Mikhail Saakashvili in condemning a "dirty aggression" that revived memories of the Cold War. It was, after all, the first time since the collapse of the Soviet Union that a Russian army had crossed an internationally recognised border. The German Chancellor Angela Merkel, who grew up in the eastern half of a divided country, warned that Russia's membership of the G8 might be frozen as a result. Some other leaders of former Communist states that have joined the EU since 2004 called for even harsher penalties. Yet the French President Nicolas Sarkozy, who brokered the ceasefire between Moscow and Tbilisi in his role as EU president, noted ruefully that Europe's own vulnerability lay at the heart of the dispute. We depend on Russia for a third of our oil and 40% of our gas, and such a dependency poses its own threat.**

The debate in Brussels highlighted the way the Old and New Europe see Russia differently. It also focused attention on the difficulty of rebuilding trust in the shadow of warfare and recession. Two months before the outbreak of war in the Caucasus, at a Russia-EU summit held in the West Siberian city of Khanty-Mansysk, the two sides agreed to begin negotiating a new Partnership and Cooperation Agreement (PCA). The first round of negotiations took place in July 2008, but the European Union postponed the second round in the wake of the military conflict in Georgia. This hiatus lasted until November when the estranged partners held a summit meeting in the genteel surroundings of Nice.

Talk of partnership and co-operation between Russia and the European Union can seem quaint. History is partly to blame. In the aftermath of the Cold War, it became fashionable in Western Europe to assume that the Russian Federation might transform itself according to western standards of market economics and democracy. Such optimism led to the PCA. Perceiving a new democratic spirit in Russia under former president Boris Yeltsin, the EU signed the accord in 1994, outlining the framework for future relations. The original 10-year agreement, encompassing assistance to help reform Russia's economy, legal system and democratic institutions, took three years to ratify so it didn't expire until 30 November 2007.

The intervening decade has seen the accession to the European Union of former Warsaw Pact countries whose leaders remain sceptical of Russia's intentions. This enlargement of the EU has influenced the renegotiation of an agreement covering political and economic cooperation, energy, justice and home affairs. Until last summer, Poland and Lithuania vetoed the beginning of talks. Warsaw was infuriated by Russia's decision to ban the import of pork and vegetables from Poland. Vilnius was demanding compensation for the Soviet "occupation" and a more recent suspension of Russian oil deliveries. Both countries objected to the original agreement which gave Yeltsin's administration the benefit of the doubt over its "respect for democratic principles and human rights". Under Putin (and Medvedev), law and order in Russia may have improved, as have the predictability and stability of legal institutions. Yet the government is less bound to the law, and human rights seem more threatened by the state. The economic background to the PCA may hold the key. The European Union struck the original agreement with a poor country still emerging from the post-Communist twilight. For at least half a dozen years, under Putin, the boom in oil and gas prices made Russia prosperous, shrinking debt and boosting foreign exchange reserves. Now signs are everywhere that the Russian economy is in deep trouble, from the tumbling oil price and the dramatic 70% drop in the stock market in recent months to news of layoffs among major manufacturers like the KamAZ truck manufacturer and GAZ car maker.

Many people would argue that Russia today is a different country from 1998, one with a highly promising economy that carries far fewer business risks than it once did. Of course it is unlikely to escape a severe slowdown in the first half of 2009, due to the global financial crisis, but Russia is in much better shape to weather the storm than other economies, according to Chris Weafer, chief strategist at Uralsib, and this is partly due to the high level of financial reserves, and partly to the slow development of the economy, which means that it is not greatly exposed to the world recession.

Nevertheless it is hard to ignore the impending crisis in Russia's banking sector, especially amid reports of increasing loan defaults and recent legislation on bankruptcy, specifically targeting individuals and SMEs in debt to banks. There is clearly a risk if lending gets out of control and/or the rouble continues to depreciate. Companies and individuals are struggling to service the debt. In October 2008, the state-owned National Development Bank (also known as VEB) granted Oleg Deripaska's Rusal and Mikhail Friedman's Alfa Group $4.5 billion and $2 billion bailouts respectively after they failed to meet margin calls on loans from syndicates of western banks. News of the bailouts came as a surprise because Deripaska and Freidman had usually been considered among the best positioned and financially secure of Russia's oligarchs. Some experts believe that the Kremlin may be using the credit from VEB bank, whose chairman is Vladimir Putin, as a tool to re-nationalise some of the assets that were privatised in the 1990s. If Deripaska or Friedman is unable to repay the VEB loan, because commodity prices, a key source of Russian oligarchs' wealth, do not go up again, the shares held as collateral will fall into the Kremlin's hands. But the majority view among informed observers is that the Kremlin is just trying to re-liquify the Russian economy by depositing money with state banks, or by making it that much easier for private banks to borrow against their assets, or by using VEB to roll over foreign debt, and that it doesn't have an ulterior motive in hatching the bailout plan. This follows from Putin's comments during the autumn that recent government intervention was just a "forced measure" and "of a temporary nature."

Shifts in energy prices can disrupt power relations between Russia and the European Union. Energy *is* power. Yet, unlike Russia, the 27 EU countries have been slow to elevate oil and gas, and other fuel sources, to a priority of foreign policy — at a cost perhaps to their strategic interests in the twenty-first century. On the other hand, many Russian liberals argue that European policy towards Russia has helped to make the country more nationalistic. Triumphalism after the cold war caused the same sort of resentment in Russia as the settlement after the First World War did in Germany. America's unilateral withdrawal from the Anti-Ballistic Missile Treaty, its plan to put a missile-defence system close to the Russian border and NATO's expansion into Eastern Europe played into the hands of Russian hardliners. The West's recognition of Kosovo in February 2008 led, in September, to Russia's recognition of South Ossetia and Abkhazia

European leaders such as Sarkozy or Britain's Gordon Brown, who claim that Europe is in danger of sleepwalking into energy dependency on a less than reliable partner, forget that the Kremlin and its oligarchs are desperate for the cash they get from selling oil and gas. In other words, it is difficult to say that the EU states need Russian energy supplies more than Russia needs the oil and gas revenue that comes from European markets. Russia cannot develop its vast energy fields without Western capital or technology. Yet the EU has shown no tendency to use its considerable leverage to force Russia to play by the transparent, competitive rules that guide business in the western part of the continent. Competition by European firms for exploration and production rights in Russia may be part of the explanation. Nevertheless it is clear that Russia depends on Europe as much as Europe depends on Russian oil and gas. Russia-EU trade grew by 40 billion euros, to 170 billion euros, in 2008. Kremlin policy makers betray a disturbing inclination to bolster the state's influence in the energy sector, not to reduce it. Taxes on oil exports have been raised significantly and private oil companies complain that the higher export taxes are hindering efficient allocation of profits into exploration and development. State-owned export facilities have grown at breakneck speed, while private projects have grown more slowly or have been met with roadblocks by state-owned companies Gazprom and Transneft. The way the state-owned company Rosneft obtained the YUKOS unit Yuganskneftegaz remains a matter of concern, as does the fact that leading industry figures have come under criminal investigation by Russia's Procuracy General.

The long-term energy security risk, then, is not just a matter of an energy tyrant holding the world to ransom, as it is sometimes characterised in the European media. Russia still maintains hybrid trade regimes with the other former Soviet states, reflecting the web of economic interdependence that had dominated commercial relations within the Soviet Union. Recent disputes with Ukraine, Belarus and Georgia have revealed that many of the non-Russian republics remain dependent on Russian energy, for which they continued to pay heavily subsidised prices until recently. As Russia raises fuel prices closer to world market levels, the other republics are finding it increasingly difficult to pay for Russian oil and natural gas, and as a result Russian trade with the so-called 'near abroad' — the other former Soviet states — is likely to deteriorate.

Yet the danger facing Europe is less that of energy dependency than that of an unpredictable world leading to political tensions between Russia and its EU partners. Many capitals in the European Union are assessing the consequences of the geopolitical changes and how these might affect their national energy and foreign policies. National interests do not add up to European interests, because the energy mix in the various member states is still different, and the risks to security of supply are asymmetrical.

The autumn summit in Nice signalled a fresh start on both sides. Old Europe persuaded Poland not to obstruct the PCA negotiations. Only Lithuania failed to rally to Sarkozy's call for unity. Nevertheless the French president said he believed that all EU members would come to see the mutual benefits of continued partnership with Russia. He even hinted that he would be prepared to show support for Russia in its efforts to join the World Trade Organisation. Russia needs to join the WTO because a third of its GDP depends on foreign markets, so it is interested in working out market rules. WTO membership is also a key driver for wider domestic reforms in Russia. Moscow emphasises the importance of increasing the role of foreign trade in its economy. It exempts members of the Commonwealth of Independent States from custom duties and taxes imports from countries with most-favoured-nation status, including the European Union, at base import-tariff levels. Russia's WTO accession bid has, since 1 January 2001, simplified Russia's system of import duties. But in the last stage of accession talks, Russian negotiators at the same time signalled that the government would continue to use agricultural subsidies to boost competitiveness. Russia insists on supporting the national agricultural sector at a level of 9.5 billion dollars, with export subsidies at 0.7 billion dollars.

However, neither trade nor the economy was the key topic at the summit. European leaders were more concerned about President Medvedev's intention to deploy Iskander anti-missile systems in Kaliningrad to counter US missile defences in Poland and the Czech Republic — that is, if the new US Administration goes ahead with these plans in the immediate future. It was nice, in Nice, that Moscow and Brussels decided to resume the PCA talks but, as Russia's EU envoy Vladimir Chizhov duly noted, it is not the beginning but the conclusion of the talks that will signal a breakthrough. The biggest challenge for the European Union will be to find a new agreement that neither appeases Russia nor ignores its problems. ■