

EU-Russian Economic Integration: Gridlocked by the Partnership and Cooperation Agreement?

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Abstract: *EU-Russian economic integration and the growing institutionalisation of bilateral relations is, partially, the way out of global recession. Due to political obstacles the pace of economic integration is rather slow. Unable to overcome the 'lowest common denominator' attitude towards each other, the EU and Russia are gridlocked by existing agreements. In times of global economic recession a new cooperation agreement is crucial for intensifying trade, which positively affects national welfare in both the EU and Russia. Probably the most significant factor promoting further deepening of economic integration is the position of business community for which further institutionalisation of the relationship is vital. There is no consensus on either the timeliness or the shape of a future agreement. However, research should continue to identify the potential of new forms of economic relations.*

Keywords: EU-Russian relations, Partnership and Cooperation Agreement, Business Cycles Theory

Introduction

2010 seems to end under unfavourable economic conditions. The global economic crisis – so carefully denied by many political leaders in 2007 – is, at the end of 2010, still an unfortunate reality. Neither Russia nor the enlarged European Union (EU) is able to adequately cope with this truly global phenomenon. On one hand, after two consecutive quarters of contraction in 2008 the Eurozone, together with the United Kingdom, had fallen into a technical recession for the first time ever (EurActiv 2008). Even though in the end of 2009 Eurostat¹ reported that the GDPs for the 16 countries of the Eurozone grew by 0.4 percent from the second quarter, it was still 4.1 percent lower

¹ The European Union's statistical agency.

than a year earlier (NY Times 2009). During the second quarter of 2010, GDPs increased by 1 percent in both the Euro Area (Eurozone²) and the EU27 (TradingEconomics 2010), however unemployment rate still hovers at around 10 percent (Eurostat 2010). On the other hand, the World Bank estimated that the fall in Russia's GDP growth rate from 6.5 percent in 2008 to just 3 percent in 2009, was due to a rapid deterioration in nearly every sector: the banking system, the real estate market, construction, the metallurgical sector and, of course, the price of oil (Business Week 2008). According to the annual report by the Organisation for Economic Cooperation and Development (OECD), the recovery is gaining momentum due to the rise in oil price since early 2009: the real growth of GDP is 5.5 percent in 2010 and it is estimated to be 5.1 percent in 2011 (OECD 2010).

The economies of EU members and Russia are interdependent: as of 2009 Russia is the EU's third main trading partner with the total turnover of almost €180 billion, while for Russia the EU is *the* main trading partner with €150 billion turnover (European Commission DG Trade 2010). Over the past decade two tendencies have emerged: first is an overall intensification of trade and the second is a growing trade deficit on the side of the EU. Such economic relations are framed by the Partnership and Cooperation Agreement (1997) which is, according to numerous scholars from both the EU and Russia, out of date. There is no consensus about the need for a new cooperation framework and the possible shape of a future agreement remains unclear. The spectrum of opinions is rather broad; while some scholars impugn the need for a new framework claiming that neither part is prepared for it (Barysch 2008, Blockmans 2008), others advocate its crucial importance for stimulating trade in times of global crises, and discuss the appropriateness of the various forms of a new agreement (Stent 2007, Emerson et al. 2006 and Fedyashin 2008).

In autumn 2008 – after several months of idleness in EU-Russian negotiations caused by the Georgian-Russian military conflict over the fate of South Ossetia – it was concluded in the Nice Summit (November 2008) that negotiations on a new cooperation agreement should be continued. Driven by different approaches to foreign trade, mercantilist (neorealist) Russia and liberal EU cannot reach consensus on the future shape of the agreement (see Balaam and Veseth 2008; Donaldson and Noguee 2005).

The main thesis of this work is that *in times of global economic recession a new cooperation agreement is crucial for further intensification of trade and positive development of the EU-Russian economic relations*. This idea is based on two assumptions. First, according to the classical Business Cycles Theory, depressions (or recessions) occur when there is not enough demand for all the

² A monetary union among 16 European Union member states that have adopted the euro as their sole official currency: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

goods and services that an economy produces. Such falling demand is a normal part of so-called ‘business cycle’ (Caldwell and O’Driscoll 2007: 1). Mid-2007 was a ‘peak’ of the cycle after which the phase of actual recession started (Barrell and Davis 2008: 2). Second, classical reading of theories of foreign trade assumes positive outcomes of trade intensification on a national economy – welfare creation effect.³ Consequently, trade intensification should be used to compensate for low demand caused by a global crisis. In order to justify the central claim of this work, the following questions should be answered:

1. Is EU-Russian integration gridlocked by the existing Partnership and Cooperation Agreement?
2. Is a new agreement inevitable in times of global economic recession?
3. Are there many realistic options on the future shape of the agreement?

Due to the complexity of the issue, the analysis of this work focuses exclusively on the economic side of EU-Russia relations. There are other limitations. First, this research treats EU members not as bilateral trading partners of Russia, but as a single trading actor: the EU.

The work is organised as follows. The first section explores the evolution of EU-Russian economic cooperation while the second section presents the latest bilateral trade results as influenced by the global economic recession. This is followed by the third section which deals with an integration gridlock created by the Partnership and Cooperation Agreement. The fourth section justifies the idea that an integration *upgrade* is the way out of global recession and the fifth section examines the shape of a future agreement. Finally, section six summarises the key findings and offers direction for further research.

The Roots of EU-Russian Economic Cooperation

Even though the potential positive welfare effects of deepening economic integration between the EC/EU and the (then) USSR were known long before the 1990s (Viner and Meade’s customs union theory, gravity models of international trade, etc.), political obstacles prevented such steps for more than half a century. This situation led to a lack of institutionalisation between the EC/EU and Soviet Council for Mutual Economic Assistance.⁴

³ Ricardo’s theory of comparative advantage; Heckscher-Ohlin’s general equilibrium model of international trade; Viner and Meade’s models of custom union; Mundell’s theory of optimal currency area; Baldwin’s domino theory, gravity models of international trade by Ivanenko (2007) and Papanikos (2005) .

⁴ Council for Mutual Economic Assistance, 1949-1991, the system of trade between Eastern Bloc participants: USSR (Azerbaijan, Armenia, Georgia, Estonia, Latvia, Lithuania, Russia, Belarus, Ukraine, Moldova, Kazakhstan, Uzbekistan, Turkmenistan, Kyrgyzstan, Tajikistan), its Socialist allies in CEE (Bulgaria, Czechoslovakia, East Germany (until 1990), Hungary, Poland, Romania), Mongolia and overseas allies (Cuba and Vietnam).

Indeed, official relations between the EC/EU and the Russian Soviet Federal Socialist Republic (RSFSR) could not emerge until Soviet leader, Mikhail Gorbachev, launched *perestroika* and *glasnost* – broad economic restructuring and the promotion of openness, transparency and freedom of information. It not only upgraded bilateral trade in quantitative terms, but also promised the USSR, and its allies, the ability to achieve the ambitious goal of integration into the global economy. The EC/EU, on the other hand, got the chance to ease the rigid bipolar international system and ‘normalise’ relations with the Soviets. A Joint Declaration on future cooperation between the EC/EU and USSR was signed in June 1988. According to the *Baltic Course* magazine, it was initiated by CMEA (Eteris 2004: 2). The following year a Trade and Cooperation Agreement between the EC/Euratom and the USSR was concluded for a 10-year period, a ‘modest and prudent first step’ in developing an economic and political relationship (Dinan 2005: 535). These arrangements did not last long, since both the USSR and CMEA ceased to exist in 1991.

Partnership and Cooperation Agreement (PCA)

In 1994, soon-after the beginning of its transformation process, Russia signed a ten-year Partnership and Cooperation Agreement with the EU. It entered into force in 1997 and established a legally-binding relationship between the counterparts. Practically, the PCA covered trade in goods and services; contained provisions on the movement of workers; prescribed the approximation of legislation; and encouraged parties to cooperate in several other policy areas (Blockmans (2008): 169). The main economic aims at the moment have been stated in the Article 1 of the agreement:

1. to provide an appropriate framework for the trustful dialogue and effective cooperation;
2. to foster sustainable development by promoting trade, investment and harmonious economic relations based on the principles of market economy;
3. to strengthen economic freedom;
4. to support Russia in transition to a market economy;
5. to create the necessary conditions for the future Free Trade Area (PCA 1997).

The existing agreement does not reach the level of a FTA so it should be treated as a preferential cooperation agreement (Cihelková 2007: 243). In order to realise the economic goals of cooperation, Russia was granted Most Favoured Nation (MFN) status as it was a WTO member (Hnát and Cihelková 2007: 53). Practically, it meant the conclusion of an interim agreement that removed some duties imposed by the EU on imports from Russia and granted better protection of intellectual property rights. At the same time, both parties

could use an ‘emergency’ clause in case of either quantitative or other kinds of *dumping* against domestic producers. It was especially relevant to sectors under competence of ESCS and Euratom. Therefore the main economic benefit from the PCA was the elimination of quantitative restrictions on imports originating from the former USSR (used, in fact, even before the collapse of the Soviet Union), and in establishing cooperative frameworks in specific areas – business and investments, services, capital, intellectual property, legislative and economic cooperation, research and development, technologies, education, energy, environment, transport, telecommunications etc. Even though the PCA is (relatively) highly prioritised in the system of external economic relations of the EU, it does not lead to a total elimination of tariffs, as it is in the case of Stabilisation and Association Agreements between the EU and Balkan countries (Cihelková 2003: 620). The PCA, in this sense, does not contain provisions about the liberalisation of the movement of goods, persons, services and capital (Arbatova 2006: 106). Besides, ‘MNF status in recent years has almost become the lowest common denominator of preferences available from trading partners’ (Brabant 1998: 1).

The PCA established the initial institutionalised framework of EU-Russian economic cooperation. First, the Summits of Heads of State/Heads of Government (twice a year) define the strategic direction for the development of EU-Russia relations. Second, the Cooperation Council allows ministers-in-charge to meet as often as necessary to discuss specific issues.⁵ Councils are usually held with the participation of Foreign Ministers and Ministers of Justice and Home Affairs, Energy, Transport and the Environment. Third, a Parliamentary Cooperation Committee – consisting of representatives of both the European Parliament and the Russian Parliament (State Duma and the Council of the Federation) – allows members of both Parliaments to meet on a regular basis to exchange views on the actual economic situation. Fourth, senior officials and experts meet as often as needed to discuss technical aspects of cooperation (EC/EU 2007: 4-5). There are also regular meetings of Foreign Ministers, senior officials, Ambassadors and consultations on broader social issues, such as human rights protection. However, these frameworks are of a political agenda and rarely deal with economic issues.

Since the Council can only produce recommendations (that are legally non-binding), the development of the PCA regime was subject to additional agreements between the EU and Russia (Blockmans 2008: 169). These were sector agreements based on treaties of the EC and EURATOM. They first covered trade in textiles, but later extended to other areas such as steel, science and technology, nuclear safety and nuclear fusion, visa facilitation and readmission. Steel and textiles are the main sectors covered by bilateral trade agreements. They should end the day Russia becomes a member of the WTO.

⁵ During the EU-Russia Summit (May 2003), it was decided to transform the Cooperation Council into the Permanent Partnership Council in order to create a stronger, more efficient and more transparent tool of cooperation management.

Another cooperation instrument was tested – a four-year Common Strategy of the EU on Russia, signed in Cologne in 1999. It aimed at consolidating democracy; promoting the rule of law, institutional reforms and integration of Russia into regional and global institutions; creating a secure and stable Europe; protecting environment and fighting criminality and illegal migration (Cihelková 2003: 626). However, this approach was treated by Russia as unilateral, and so Russia replied with a medium-term regional strategy.

Common Economic Space

At the St. Petersburg Summit in 2003, the parties agreed to reinforce economic cooperation by creating four Common Spaces on the basis of common values and shared interests.⁶ This framework did not contradict the existing PCA, however it overtook the 1999 Common Strategy, the application of which was extended only once, until June 2004 (Blockmans 2008: 171). The Moscow Summit in May 2005 adopted Road Maps to act as short- and medium-term instruments for the implementation of the Common Spaces. Particularly, they aimed at expanding the ongoing cooperation; setting out further objectives; and determining the concrete realisation steps. The Common Spaces are, in fact, very similar to Action Plans of the European Neighborhood Policy⁷ except for exclusion of Common Space of human rights and democracy.

The Common economic space was designed to establish an open and integrated market between the EU and Russia which would be based on the principles of non-discrimination, transparency and good governance, and which would reflect the ongoing business dialogue at EU-Russian Round Table of Industrialists.⁸ The framework was intended to remove trade and investment barriers and, therefore, to promote competitiveness. Fourteen dialogues were launched on the issues that have been covered partially: regulatory policy (i.e. promoting the gradual approximation of legislation), financial services, telecommunications, transport, energy, space, nuclear safety, environment (implementation of Kyoto protocol), etc.

⁶ The EU-Russia Common Spaces are: Common Economic Space; Common Space of Freedom, Security and Justice; Common Space of External Security (including crisis management and non-proliferation); and Common Space of Research and Education (including cultural aspects).

⁷ European Neighbourhood Policy (since 2004) is a cooperation framework by the EU dealing with the Middle East (Israel, The Palestinian Territories, Jordan, Syria, Lebanon, Libya), North Africa (Algeria, Egypt, Tunisia, Morocco) and former USSR (Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine).

⁸ The EU-Russia Industrialists' Round Table (since 1997) is a permanent international forum of the Russian and European business communities. It operates under the auspices of the European Commission (DG Enterprise and Industry) and the Russian Government (Governmental Commission of the Russian Federation on Economic Integration, Ministry of Industry and Energy – Minpromenergo; and Ministry of Economic Development - Mineconomrazvitiya).

Financial and Technical Assistance

It should not be omitted that the EU also provided regular financial and technical assistance to transitional Russia. It mainly aimed at implementing important reforms (legal system, nuclear security, financial sector, etc.). Financial aid was included as a part of the PCA (Title X, Articles 86-89). The main framework was Technical Assistance to the Commonwealth of Independent States (TACIS). It was realised through national action, regional, cross-border cooperation, and small projects programmes. Between 1991 and 1999 the EU granted Russia almost €1.3 billion (Cihelková 2003: 625). It functioned until 2006, and then it was incorporated into the European Neighbourhood and Partnership Instrument (ENPI). Surprisingly, ‘Russia did not object to being included in an aid instrument otherwise solely geared towards ENP countries, despite its aversion to that policy’ (Blockmans 2008: 178). According to the UK Permanent Representation to the EU, under this instrument Russia should receive almost €120 million between 2007 and 2013 (UKREP 2008). Since the beginning of transformation process, Russia had also been entitled to other sources of international aid such as, for example, the European Community Humanitarian Aid Office and European Initiative for Democracy and Human Rights.

Latest Trade Results

Despite of a rather slow pace of institutionalisation and until the beginning of global financial crisis in 2008, EU-Russian trade had been intensifying each year (see Table 1).

Table 1: The EU-27 – Russia Bilateral Trade (in billion EUR)

	2005	2006	2007	2008	2009
The EU-27: Trade with Russia					
Imports	112.591	140.890	144.527	173.617	115.392
Exports	56.696	72.308	89.106	105.153	65.598
Balance ⁹	-55.895	-68.582	-55.421	-68.464	-49.794
Russia: Trade with the EU-27					
Imports	35.525	48.622	63.183	79.323	54.828
Exports	111.942	141.061	142.690	178.475	95.848
Balance	76.418	92.439	79.506	99.153	41.021

Source: European Commission, DG Trade, July 2010

⁹ Total Trade Balance = Total Exports – Total Imports.

As of 2009, Russia became the EU's third major trading partner (after China and the US), with the amount of total bilateral trade¹⁰ growing from €108 billion in 2003 to almost €280 billion in 2008, and falling to €180 billion in 2009. Between 2003 and 2009, the EU's imports from Russia grew from €70.6 to €115.4 billion, representing 7.9 percent share of total EU-27 imports. Except for the year 2009, the annual increase in imports was steady with the average growth rate of 19.4 percent. The EU's exports to Russia also grew constantly, from €37.2 billion in 2003 to €105.1 billion in 2008 with average annual rate of 24.4 percent, but in 2009 they fell to €65.6 billion. Russia is the EU's fourth largest export partner (after the United States, Switzerland, and China). Exports to Russia represent 6 percent of the total EU exports. As of the trade balance, it is significantly negative on the side of the EU. In 2003 it amounted to -€33.4 billion, while in 2006 it reached its minimum at -€68.6 billion, improved slightly in 2007 (-€55.9 billion), in 2008 it fell again to -€68.4 billion, and in 2009 it was -€49.8 billion (DG Trade, 2010).

The EU is the main trading partner of Russia. Its share in Russia's imports is as high as 47 percent, while trade with the EU constitutes 48 percent of Russia's exports. It should be noted here that in November 2002 the EU recognised Russian transformational efforts on the way to a functioning market economy by granting 'market economy status' to Russian exporters. Consequently, the EU's antidumping measures started to decrease and today they are not a major aspect in bilateral trade, as only 10 antidumping measures are currently in force. They represent less than half a percent of EU imports from Russia (EC/EU 2007: 5). Russian imports from the EU grew from €23.1 billion in 2003 to €79.3 billion in 2008 with the average annual growth of 40.4 percent; while in 2009, as a reflection to the crisis, they shrank to €54.8 billion. Russian exports to the EU grew from €61 billion in 2003 to €178.4 billion in 2008 (an average annual growth equal to 21 percent) and fell to €95.8 billion in 2009. Consequently, Russia has a strong positive trade balance with the EU, which grew from €37.8 billion in 2003 to €99 billion in 2008 and to €41 billion in 2009 (Ibid.).

In contrast, in 1993 the EU's imports from Russia accounted for 17.4 billion (ECU) (3.7 percent of total EU imports), making Russia the 6th largest import partner. Exports, on the other hand, reached 12.6 billion (ECU) (2.7 percent of total EU exports) – which placed Russia as the EU's 12th largest export partner (FiFo Ost 2008: 1). Therefore, before the conclusion of the PCA, trade between the parties was much less.

¹⁰ Total Trade = Total Exports + Total Imports.

Table 2: The EU-27 Merchandise Trade with Russia, by product, 2009 (in billion EUR)

	Agri-cultural goods	Energy	Machinery and transport equipment	Iron and steel	Chemicals	Textiles and cloth
Import	2.047	89.228	1.160	2.995	3.075	0.57
Export	6.740	1.005	28.168	0.88	10.933	2.978
Balance	4.693	-88.223	27.008	-2.907	7.858	2.921

Source: European Commission, DG Trade, July 2010

Table 2 represents the commodity structure of bilateral trade. It seems that EU-27's imports are significantly dominated by energy products. As of 2009, they accounted for 77 percent of all EU's imports from Russia (€89.2 billion) and 21 percent of total EU imports. Other goods from Russia (agricultural, machinery and transport equipment including automotive products, chemicals, and textiles and cloth) are imported more than fifteen times less than energy. This is a primary cause of the significant negative trade balance on the side of the EU. At the same time, the EU exports a wide range of products to Russia. In 2009 the list was dominated by machinery items (43 percent of all exports to Russia), chemicals (16.7 percent), and agricultural products (10.3 percent). Sales grow on almost all merchandise products, but most rapidly in transport equipment, the automotive sector and chemicals. For example, exports of automobiles to Russia grew more than three-fold between 2003 and 2008 (EC/EU 2009: 7). Even such heterogeneous structure of the EU's exports to Russia is not able to compensate for a significant negative balance of trade, which tends to expand over time.

The data on the EU's trade in services with Russia (excluding governmental services) indicates that European exports to Russia grows faster than imports: imports of services grew from €7.3 billion in 2004 to €10.8 billion in 2009, but exports grew from €9.3 billion in 2004 to €18.3 billion in 2009. Consequently, the balance of trade in services is positive at €7.5 billion (as of 2009). However, Russia's share of total EU imports accounts for only 2.6 percent and the EU's exports to Russia are just 3.9 percent of all foreign trade done by the EU. As of the EU-27 Foreign Direct Investments with Russia, the inflow is rather modest, since it was only €300 million in 2004, grew to €2.8 billion in 2005, fell to -€500 million in 2006, and grew to €3.1 billion in 2009. Simultaneously, the outflows increased from €6 billion in 2004 to €10.4 billion in 2006, but fell to -€1 billion in 2009, so the balance is negative on the side of the EU at -€4 billion (Ibid.).

It can be concluded that EU-Russian trade is dominated by several tendencies. First, there is a significant negative balance of trade in merchandise products on the side of the EU, dominated by energy products. Despite constant

growth, exports of EU-originated goods cannot compensate for such performance. Trade in services is rather insignificant with a positive balance of the side of the EU. The same is true for the FDIs: the EU invests more into Russian economy than vice versa.

Partnership and Cooperation Agreement – Gridlock

Even though the original agreement was signed for a period of ten years, it did not cease to exist in 2007; it renews on an annual basis. Article 106 of the PCA reads

This Agreement is concluded for an initial period of 10 years. The Agreement shall be automatically renewed year by year provided that neither Party gives the other Party written notice of denunciation of the Agreement at least six months before it expires (PCA 1997).

Both sides understand the need for change, but the visions differ. Brussels wants a new agreement to provide a legal basis for developments in certain policy areas over the past decade (including such sensitive areas such as the energy sector) – a detailed, comprehensive text with wide-ranging legal obligations, similar to the old PCA, or even going beyond it (Barysch 2008: 1). In contrast, Moscow claims that the existing framework was negotiated at the time when Russia was weak and confused, so the new agreement should reflect the reality of Russia's reemergence in the global economy. A simple agreement on tariff-free trade would require greater concessions on the Russian side, as EU tariff levels vis-à-vis Russia are much lower than Russian tariffs on imports from the EU (Ibid). Consequently, it wants a broad, basic agreement, primarily aimed at creating 'real equality' between the partners. The divergence of positions between the EU and Russia was expressed by Bordachev, the head of the Center for European Research at the Higher School of Economics (Moscow) who noted that

Russia wants a short, businesslike document, which would spell out the economic rules of the game between Russia and the EU businesses and government bodies... Meanwhile, the EU wants a long and binding document, which would include chapters on values, human rights and various political obligations, which Russia should undertake if it wants to be a part of Europe (Babich 2008: 2).

Additionally, both parties understand the need to respond to the global recession. In July 2008 European and Russian officials held a first round of negotiations on the new agreement, but the military conflict between Georgia, South Ossetia and Russia in August of the same year resulted in a postponement

of the second round of negotiations by the EU. Even though the Nice Summit concluded that talks should be resumed and even appointed a chief negotiators (the Commission's Director General for external relations, Eneku Landaburu, and ambassador Chizhov on the Russian side), the dialog remained fragile (Cameron and Matta 2008: 13). By May 2010, nine full negotiating rounds took place (EU 2010: 1). The process is further prolonged by the fact that Russia has to implement a number of systemic legislative changes: it has to bring its regulatory system in line with WTO rules by the end of 2010,¹¹ and since January 1st 2010, the Customs Union between Russia, Kazakhstan and Belarus is enforced. Consequently, 'a lot of work still rests with Russia but the EU is ready to continue working closely together to this end' (EC/EU 2010: 1-2).

The Logic Behind Resuming the Status Quo

While Russia is clearly motivated about the need for a new cooperation framework, the EU member states do not share consensus on this issue. Moreover, there is a debate raging on the timeliness of a new agreement. Given the complex nature of EU-Russian relations, one can assume that it is better to continue using the existing framework. Among advocates of this approach belongs, for example, Barysch, a deputy director of the Centre for Economic Reform (London). The following logic can be applied: firstly, even though the initial agreement was concluded for a ten-year period (1997-2007), there is no legal requirement to conclude a new agreement. Under Article 106 the existing PCA continues automatically in the absence of any agreement to the contrary (Emerson et al. 2006: 3). Secondly, the 2004 and 2007 enlargements of the EU had been reflected in the existing PCA though the conclusion of two specific protocols that extended the application of the agreement to the new member states of the EU, in 2006 and 2007 respectively (Blockmans 2008: 170). Consequently, the agreement covers the EU-27, so none of trade participants is discriminated. Thirdly, even though PCA is out of date in some areas, it did not prevent the parties from moving into new dimensions of integration (for example, cooperation on justice and home affairs), launching new initiatives (Common Spaces), or setting up new institutions in order to make minister-level meetings more flexible (Barysch 2008: 1). This means the existing framework is flexible enough to accommodate the adjustments and so there is no immediate need to conclude any other agreement, given the complexity of the ratification process.

The realisation of a new agreement is particularly difficult for the EU. According to a Centre for European Policy Studies policy brief, the

legal issues are particularly complex for comprehensive agreements that mix issues where the European Community has exclusive competence such

¹¹ The EU strongly supports this timetable.

as for trade policy, other areas such as energy where the competences are shared between the European Community and member states, and other areas such as foreign and security policy where the formal competence lies mainly with the Union as such and the member states (Emerson et al. (2006): 4).

In other words, the institutional architecture of the EU is based on the principle of attributed competence; therefore every international agreement concluded by the EU must be grounded in one or more of the legal bases offered by the EU Treaties. Consequently, a future agreement must directly refer to the division of competences within the EU (EU-Russia Centre (2007): 6). Also, this could open a Pandora's Box on the debate on the foundation and scope of Community competences. The conclusion of a comprehensive agreement that would cover issues of four Common Spaces would require a multi-pillar approach by the EU, which would be the first example of its kind – clearly unrealistic to the proponents of this position, since the EU Treaties provide no clear guidance as to how such a multi-pillar agreement should be concluded (Ibid.). Russia, in contrast, tends to show a more consolidated approach – a consistent willingness of a new cooperation framework. In this sense it has a stronger negotiation position, expressed, for example, by Putin's comment that it 'is difficult for us to entertain a dialogue with the EU if it has no precise, clear structures and while Europe is still in the process of taking shape' (Stent 2007: 2).

Speaking more generally, the EU should first set up a clear common position on Russia and only then start negotiations on a new agreement. Since a common position seems unrealistic, even in the medium term (due to the heterogeneity of economic interests within the enlarged Union and numerous disagreements between the EU and Russia), further deepening of economic cooperation is gridlocked.

Integration Upgrade – The Way Out of Crisis?

Probably the most significant factor promoting closer economic integration between the EU and Russia is the current situation facing global markets. In times of global recession the EU definitely needs Russian markets for its goods and services. Russia, on the other hand, needs to continue being Europe's most important energy supplier. The system of global economic governance has significantly changed since 1997 and, combined with crisis pressures, institutional reorganisation of relations is inevitable. Stent,¹² for example, believes that the existing cooperation mechanisms have failed to create a productive and comfortable relationship (Stent 2007: 4). A policy brief by the Centre for

¹² Angela Stent is Director of the Centre for Eurasian, Russian and East European Studies and a professor in the School of Foreign Service at Georgetown University (USA).

European Policy Studies summarises the popular position of proponents of a new cooperation framework (both researchers and policy-makers):

the EU and Russia need an ordered relationship because they are ever-closer neighbors ... their list of common concerns and interests is extremely long ... the EU wants its big neighbor to be the friendly and reliable partner, both on concrete matters of which energy supplies is the most important, and on matters of political values for both internal and external affairs ... Russia wants to confirm and deepen its presence and identity in modern Europe, but without being tied to the EU's all-entangling mass of legal and normative rules and regulations (Emerson et al. 2006: 11).

Another argument of the proponents of a new agreement is that the existing PCA is unable to solve many issues, mainly energy and Common Economic Space (in the sense of a potential free trade agreement). After the 22nd EU-Russia summit in Nice it became clear that energy is probably the most significant issue 'the wind in Nice smelled mostly of gas, with minor nuances of oil, coal and electricity' (Fedyashin 2008a: 1). The reason is in significant dependence of the EU on Russian energy supplies (30 percent of oil imports and 44 percent of natural gas imports come from Russia, the dependence of the EU's new members is, in some cases, as high as 90 percent), and there is no common position within the enlarged EU on how to deal with it (Ibid.). While there is still no common energy policy, trade is performed on a bilateral basis. As a result, several EU member states have concluded legally-binding contracts with Russia. That means that status quo is to last at least into the medium-term. The most obvious example is Germany's bilateral agreement with Russia on the establishment of the Nord Stream project¹³ by 2011, which seems controversial to the economic interests of several other members of the EU (particularly Poland and the Baltic States). A few days prior to the Nice Summit, the Commission published its *Energy Security and Solidarity Action Plan* to secure sustainable energy supplies in the EU and deal with challenges that Europe will face between 2020 and 2050 (EU 2008: 1). This document clearly indicates the willingness to diversify energy supplies, mainly though the promotion of the Nabucco project¹⁴ and resuming relations with alternative suppliers of energy resources, including former Soviet republics such as Turkmenistan. According to Fedyashin, this Action Plan is an indicative move: Europe needs a new PCA with Russia above all to regulate their energy relations, in particular the amount

¹³ The Nord Stream project is a planned natural gas pipeline from Vyborg (Russia) to Greifswald (Germany) by the company Nord Stream AG; estimated to cost €7.4 billion; to be completed by 2012.

¹⁴ The Nabucco project (Southern Gas Corridor) is a planned natural gas pipeline from Erzurum (Turkey) to Baumgarten an der March (Austria) via Bulgaria, Romania, and Hungary by the Nabucco Gas Pipeline International GmbH; estimated to cost €7.9 billion; to be completed by 2014.

and terms of buying, shipping and marketing natural gas, oil and electricity (Fedyashin 2008a: 2). Since the existing PCA does not have such provisions, the status quo is not productive for the energy trade.

As of the Common Economic Space, there are real negative effects of using current PCA:

the lack of clear-cut goal and solution in the current concept... [leads to] half-hearted compromises and exceptions rather than real integration. Since the goal is not there, there is no real motivation for Russia, for example, to harmonize its legislation with that of the European one ... the vague Common European Economic Space concept allows both sides to continue indefinitely the diplomatic game pretending that the relations are in progress (Pursiainen 2004: 4).

Various barriers to free trade, together with heterogeneous regulations and standards, hamper the further increase in mutual trade values. Moreover, the fact that Russia is still not a member of the WTO (which is a general prerequisite for EU-Russian cooperation) renders the existing economic cooperation almost useless. One of the most obvious examples of the effects of such idleness is the semi-functional customs cooperation that produces the growing lines of vehicles on the Russian-Finnish and Russian-Polish borders.

Finally, deeper cooperation between the EU and Russia should also contribute to the much wider circumstances than actually covered by the potential agreement. The document signed by Javier Solana¹⁵ indicated that ‘the resumption of the talks with Russia is vital for settling the Middle Eastern conflict, the Iranian and North Korean nuclear problems, frozen European conflicts and for tackling terrorism, nuclear security, stability and the financial crisis’ (Fedyashin 2008b: 1). In other words, without strong cooperation between the EU and Russia, the goals of both regional and global stability cannot be achieved.

Position of the Business Community

In contrast to a rather vague wording on elements of a future agreement by both Brussels and Moscow, the business community has developed concrete requirements for a new cooperation agreement that could reflect the realities of modern trade. These were expressed by the Joint Statement by the confederation of European Business and the Russian Union of Industrialists and Entrepreneurs in February 2008 which noted that

¹⁵ Javier Solana was the High Representative for the Common Foreign and Security Policy and the Secretary-General of both the Council of the EU and the Western European Union between 1999 and 2009.

It is in the mutual interest of the EU and Russia to move toward a more integrated EU-Russia economic relationship based on WTO membership and equal partnership ... [new agreement] should be based on economic criteria, on reciprocity and it should involve the broadest product coverage possible both in goods and services, and promote cross-border investments based on national treatment ... commercial questions must remain at the centre of the negotiations (Business Europe 2008: 1).

All trade in goods should be liberalised in the spirit of WTO rules and without *a priori* exclusions. Non-tariff barriers should be tackled, namely export restrictions, taxes, subsidies regarding raw materials and such sensitive category as agricultural goods, customs-related barriers, and discriminatory product regulations with a standstill for all new barriers as of the start of negotiations. All sectors and modes of services should be covered (especially telecommunications and financial, professional, business, transport and express delivery services) and should be based on national treatment. As of strengthening intellectual property rights, signing up to all major international conventions, full commitment to protection for intellectual property rights, and robust enforcement regimes are a minimum requirement. Detailed legal and procedural reforms necessary to ensure that intellectual property is effectively protected should be provided. Cross-border investments require transparency (publication of all elements of the investment regime), national treatment and non-discrimination against foreign investors in any regulatory measures. In order to stimulate a free flow of cross-border investments, mechanisms supporting foreign direct investments should be introduced (including joint research programs). They should not undermine or conflict with existing bilateral investment treaties between Russia and the EU's member states. Transparent, predictable, proportionate and fact-based regulations and international approaches to standards are critical on the course towards regulatory convergence, with relevant competition policy elements included in the agreement. Notwithstanding the WTO, as the trade rule-making body par excellence, EU-Russian bilateral negotiations should also be a tool to ensure best practices in trade facilitation and bilateral customs cooperation. Finally, a new agreement should contain a binding and effective dispute settlement and mediation mechanism that could be directly accessed by both European and Russian companies (Business Europe 2008: 2-3).

It is a natural reaction of the business community to the fact that the existing PCA does not reflect modern economic realities. At the same time it is clearly understood that the goals mentioned above are not easily agreed upon by politicians as 'each set of issues should be considered within the appropriate framework and according to an established schedule ... negotiations for an agreement on economic cooperation should be dealt separately from other considerations' (Ibid). A strategy which distinguishes between the economic

dimension of cooperation and other dimensions (political, security, etc.) is similar to the asymmetrical integration approach by the EC in the 1990s, when progress on the creation of the monetary union was differentiated from the political union formation (Cihelková and Jakš 2004: 23).

Given the relative success of this method in case of the EU (today there are already 16 members of the Economic and Monetary Union, while the political union is still under formation), the same principle should also apply to EU-Russian relations, since they are of a very complex nature and, therefore, cooperation is extremely volatile to political circumstances – the result of the political conflict between Russia and Georgia in August 2008 – the frozen negotiations on a new cooperation agreement. Following this reasoning it becomes clear why the negative list approach¹⁶ is advocated for such areas as service and cross-border investments. It facilitates further integration through avoidance of conflicts over the classification of new service/investment sectors. Reduction of excluded areas is a matter of removing them from the schedule, which indisputably eases the cooperation.

Summarising the requirements of the new agreement by the *actual* actors of EU-Russian trade, it seems clear that relations are to be governed by WTO rules, so the accession of Russia into this organisation is crucial for business entities on both sides. At the same time, the bilateral nature of EU-Russian relations should not be underestimated, since the conclusion of such agreements proved to be less time consuming in comparison to multilateral ones. There is a clear need for a more flexible cooperation framework accompanied by enforceable regulations. The position of the business community is too idealistic, since it is driven exclusively by economic motivation. Politically, not all the ideas can survive (for example, a full liberalisation of the agricultural sector seems very problematic). Still, the position of the factual actors of international trade (i.e. transnational corporations) continues to be crucial, since any institutionalised cooperation aims at stimulating actual trade flows.

The Role of German Ostpolitik

Notwithstanding obstacles, there is a factor that does – or at least has potential to – promote the conclusion of a new EU-Russia agreement, namely the continuation of German *Ostpolitik*¹⁷ – a product of history, geopolitics, and, increasingly, economics. Germany is Russia's most important political and trading partner in Europe and is the EU's engine for the EU's policy to

¹⁶ In an international agreement, negative list consists of those services to which the agreement will not apply, the commitment being to apply the agreement to everything else.

¹⁷ German Ostpolitik is a term for the 'Change Through Rapprochement' policy (as advanced by Egon Bahr, 1963) – the efforts of Chancellor Willy Brandt (since 1969) to normalise his country's relations with East European nations, with special attention given to relations with Russia

Russia. Such a 'special' relationship can be followed, for example, in the close personal ties between Schroder and Putin which lead to the concept of a new German policy towards Russia – 'Change Through Engagement' – advocating a more intense engagement with Moscow and rejecting attempts to link close bilateral ties to changes in Russia's domestic policies. After Merkel became Chancellor in 2005, the relationship became more pragmatic: 'the daughter of a West German pastor who emigrated to GDR, Merkel grew up in East Germany, speaks Russian, experienced decades of Soviet occupation there and thus has more sceptical view of Russia than did her predecessor' (Stent 2007: 2). So the political dimension of integration tended to intensify. Nevertheless there was still much more continuity than change in German Ostpolitik. Germany is a rare member of the EU, which realises Russian aspirations in the post-Socialist space: not only it intensifies economic integration in order to stimulate bilateral trade, but it actually opposes the early membership of Georgia and Ukraine in NATO – a signal of predominance of economic mode of thinking.

The economic dimension of this 'Moscow-Berlin Vector' became visible during the conclusion of the agreement on the Nord Stream undersea gas pipeline that, in some sense, contradicted the objectives of the EU; fundamentally challenging the creation of a common energy policy. Consequently, strategic relations with Russia seem to be more important for Germany than the controversies within the enlarged EU produced by this approach (main tensions with Poland, Lithuania and Sweden). Since Germany is influential within the EU (see Dinan 2005 and Gillingham 2003), its pragmatic and positive position to Russia has resulted in a constant economic integration effort. Such a strong partner is indisputably beneficial for Russia when dealing with those EU member states which oppose the deepening of EU-Russian cooperation. At the same time, the bilateral approach of Germany towards Russia slows down the consolidation of a strategy on the Community level – a requirement for a future agreement to become a reality.

The Shape of a Future Agreement

Even though much of the analysis has been devoted to questioning the appropriateness of a new agreement, the agreement itself is usually ill-defined and simply labelled a 'new PCA.' At the same time, any new agreement should definitely differ from the existing one in order to, first, bring qualitative change into the relations and, second, survive a global economic recession. In 2006, the Centre for European Policy Studies summarised the most popular scenarios of post-2007 EU-Russian relations as raised by both European and Russian scholars.

Table 3: Six Scenarios for Future EU-Russian Relations

Scenario 1	Retire the PCA without replacement by a new treaty The PCA would be retired because it has not been so effective and has also become increasingly obsolete, and overtaken by subsequent initiatives. But it would not be replaced by a new treaty
Scenario 2	Extend the status quo The PCA would continue to live on, as provided automatically by Art. 106, alongside the continuing negotiation of operational sectoral agreements, each of which would follow its own timetable
Scenario 3	Extend the status quo, adding a Political Declaration on Strategic Partnership The previous scenario is retained, with the only difference that there is a Political Declaration adopted at summit level providing an updating of de facto system as it has emerged and continues to develop
Scenario 4	Replace the PCA with a short Treaty of Strategic Partnership A simple variant of the preceding scenario would turn the Political Declaration into a legally-binding Treaty and the PCA would be repealed
Scenario 5	Replace the PCA with a comprehensive Treaty of Strategic Partnership A comprehensive new treaty, replacing the PCA, would give binding form to the subject matter of the Four Common Spaces, including annexed protocols with various sector-specific agreements, and updated institutional provisions
Scenario 6	A Treaty of Strategic Union A short, but a very ambitious treaty, raising the level of mutual commitment to deep cooperation in the affairs of Europe to the highest possible level. This is signalled by the name – Treaty of Strategic Union

Source: Emerson et al. 2006, pp. 8–10.

Table 3 represents six possible solutions to the current gridlock in EU-Russian economic integration. Emerson, Tassinari, and Vahl (2006) evaluated each scenario in terms of the content and timing; and concluded that four of them are, in fact, unrealistic.

First, scrapping of the existing PCA without replacement is nonsense. Since Russia is still not a member of the WTO, the removal of the present legal basis is inefficient: that would risk signalling or being interpreted as a political rupture, especially taking into account the current uneasy atmosphere between the two parties. ‘[If] the agreement remains unchanged while relations are increasingly built on new parallel rules and regulations, it will become a burden on bilateral relations, causing irritation and disagreement, while pushing the sides back into the past’ (Emerson et al. 2006: 8). Second, even if retaining the PCA as the political framework (according to Scenario 2) provides a common denominator to uphold a kind of ‘peaceful coexistence’ between the parties, the business agenda should be substantial, therefore it should be minimally politicised – that is not very realistic. The third scenario adds a Political Declaration to the strategic partnership of the EU-Russian relationship in the spirit

of the Declaration between the EU and India of 2003. However, the cases are too politically different: ‘the EU and India seem to have got closer and faster to a viable and unambiguous model for formalizing their cooperation than has been the case between the EU and Russia’ (Ibid.). The fourth scenario supposes identical substance to the previous one, but gives the top document the form of a treaty, rather than a political declaration. In legal terms it means the highest level of obligation and ratification process, which, keeping in mind the extension of the existing PCA to the 12 new EU member states was seriously influenced by pure political obstacles – is, again, not realistic.

The fifth scenario deserves more attention, because it is a more realistic attempt to upgrade the relationship in both qualitative and quantitative terms. Its main proponent, Arbatova¹⁸ calls it an ‘Advanced Partnership/Association Agreement’ – a comprehensive treaty. As of the Common Economic Space, the following particular objectives should be established: the free movement of goods, services, persons, and capital; the development of compatible standards and regulations ensuring the implementation of the four freedoms and the equality of competitive conditions; the harmonisation of relevant legislation and close cooperation in other spheres of economic policy to the extent necessary for the effective functioning of the Common Economic Space. The section on the Common Economic Space should include a provision on the establishment of a timeframe for the full liberalisation of trade in goods within 10 to 12 years (Arbatova 2006: 108-109). However, such a comprehensive treaty would again involve lengthy negotiations to progress beyond the content of the PCA and the newer Four Common Spaces: ‘The process has the hazard of having to bring so many sectoral negotiations to a point of maturity at the same time’ (Emerson et al. 2006: 9).

Another Russian scholar, Bordachev, proposed a final scenario termed the ‘Strategic Union Treaty’ that would represent the creation of pan-European integration (to include the EU and Russia) and that is, according to Emerson, Tassinari and Vahl (2006), analogous to a certain extent with the French-German reconciliation (Emerson et al. 2006: 16). On the other hand, Russia’s desires for a kind of transatlantic relationship,¹⁹ in which relations would be based on reciprocal recognition without any bilateral, legally binding framework. However, both models, although interesting in the future, are not acceptable to the EU at present due to Brussels’ perception that Russia does not fulfil economic (WTO membership and functioning market economy) and political (full democracy, rule of law, protection of human rights) standards to embrace such type of relationship (Ibid).

¹⁸ Dr. Nadezhda Arbatova is Head of Department on European Political Studies, Institute of World Economy and International Relations (Moscow).

¹⁹ Transatlantic relationship refers to the historic, cultural, political, economic and social relations between countries on both side of the Atlantic Ocean – usually between the United States, Canada and the countries in Europe.

Conclusion

In times of global economic recession theories advocating the importance of international economic integration in stimulating trade (and, therefore, improving national welfare) become very relevant. Understanding the circumstances of economic cooperation between the EU and Russia is significant for understanding the rationale for new forms of economic relations. The topic should be further researched on the potential effects of various types of integration schemes on the amount of trade flows, whereas assumption that foreign trade creates national welfare should be supported by testing appropriate gravity models. The research of the effects of Russia's WTO accession on EU-Russian trade also deserves more attention.

Comparing the arguments of opponents and proponents of the next step in further economic integration between the EU and Russia, it can be concluded that even though negotiations would not be easy, they are inevitable. The weaknesses of the existing framework are numerous, while bilateral trade increases each year, even in times of a low aggregate demand. If the status quo resumes in the medium-term, the existing cooperation framework risks becoming a real obstacle to the development of harmonious economic relations between the enlarged EU and Russia – that is, according to classical theories of international trade, beneficial for neither side, especially in times of global economic recession.

Keeping in mind the strengths and weaknesses of each integration scenario offered by academics, it seems that the only possible or realistic model is based on negotiating multiple pragmatic and tangible sector-specific agreements, each adapted to the most appropriate timing and format. Even though a model Treaty of Strategic Union is an alluring option, geopolitical and economic attitudes of the EU and Russia are too divergent to make that happen in the short- or medium-term.

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