

Is The Common Economic Space Doomed?

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Background: Re-thinking EU-Russia relations

Mutual disillusionment has been the main feature of EU-Russia relations in recent years. This was perhaps inevitable: when the EU and Russia first started to build a relationship in the early 1990s, they knew little of each other but expected a lot. Russia – economically distraught and struggling to shake off the communist past – was keen to join a ‘common European house’. The EU was happy to help, on the assumption that Russia would follow the path of the Central and East European countries towards liberal democracy and market capitalism. The EU gave Russia money, trade and advice. It also offered a gradual transfer of its own laws, policies and standards of democracy, not only to help Russia to become a better place but also to enable it to gradually integrate with the Union. Although officially dubbed a ‘strategic partnership’, this original EU strategy was very much built on the assumption that Russia wanted and needed the EU’s help.

By 2003 it had become abundantly clear that the initial blueprint was not working. Russia, with its weak bureaucracy and often cavalier attitude towards the law, would have struggled to take over EU rules, even had it wanted to. But an increasingly self-confident Russia started to question the basic assumption that it should align itself with European norms, standards and values. A combination of oil windfall revenue and almost unprecedented political stability under President Vladimir Putin were behind Russia’s growing assertiveness. The EU looked on helplessly as the Putin administration rolled back civil liberties, took control over sections of the mass media, tightened its grip over the energy sector and made angry gestures towards its smaller neighbours.

EU-Russia relations, meanwhile, have made little headway. Despite a proliferation of co-operation agreements, working groups and dialogues, progress in most areas has remained frustratingly slow. Today, grand summit declarations can no longer hide the fact that the two sides do not agree on what their partnership should look like. Day-to-day dealings between the two sides are marred by misunderstandings and mistrust. Disagreements abound, be it over elections in Ukraine and Belarus, disrupted gas supplies or fees that European airlines pay for flying over Siberia.

Russia and the EU: basic figures

	EU-25	Russia
Population, million	459	143.4
Area, 1,000 km ²	3,191	17,075
GDP, US\$ bn	13,400	764
GDP per head, US\$	29,200	5,300
Exports, US\$ bn	3,920	240
Imports, US\$ bn	3,960	125

Sources: European Commission, EIU.

Both the EU and Russia have begun to rethink their mutual relationship. There has been a noticeable shift from declaratory diplomacy to pragmatic co-operation.¹ At a time when many observers talked about a 'crisis' in EU-Russia relations, there have been multiple small successes. For example, over the last three years, the EU and Russia have managed to: agree the terms of Russia's WTO accession; extend the PCA to the new member-states; make it easier for people and goods to move between Kaliningrad and Russia proper; thrash out plans for building four 'common spaces'; re-launch their security and defence co-operation; set up new co-operation forums, such as the 'permanent partnership council' for transport questions and an expert group on removing trade barriers; promise to ease visa requirements; sign a declaration on non-proliferation and a tax deal; established a new European Institute in Moscow to train more Russia EU specialist; and intensify co-operation in counter-terrorism and between Russian police forces and Europol.

The experience of working together in all these different areas – frustrating as it may be at times – is itself valuable. It familiarises Russian officials with how the EU works and vice-versa. It is teaching the EU and Russia a lot about what they like and dislike about each other. Diplomats and officials are now spending less time on debating principles and 'shared values'. Instead, they are exploring how common or diverging values and interests impact on everyday co-operation.

Trade and the common economic space

Trade and energy must be at the heart of this new approach because it is in these areas that mutual and shared interests are strongest. The value of EU-Russian trade has grown by more than 70 per cent over the last five years, and by 400 per cent over the last ten. In 2005, trade turnover reached €163 billion, with Russia exporting €107 billion to the EU and the EU selling €56 billion worth of goods to Russia. The resulting trade surplus – a whopping € 50 billion last year – is Russia's biggest source of foreign exchange.

Companies from the EU are also big foreign investors in the booming Russian economy. Eurostat reports that the stock of EU foreign direct investment (FDI) in Russia had reached almost € 20 billion by the end of 2004 – and FDI inflows have accelerated further since then. Such statistics need to be interpreted carefully, since a lot of the FDI that originates in the EU is really repatriated Russia flight capital. For example, the Netherlands and Cyprus (both preferred locations for Russian offshore companies) each account for around 30 per cent of the stock of Russian FDI. Nevertheless, there is little doubt that West European companies are increasingly investing in the Russian economy.

EU-Russian trade, € billion

	2001	2002	2003	2004	2005
EU Exports to Russia	31.4	34.3	37.1	45.8	56.4
EU Imports from					
Russia	63.0	62.0	67.8	80.7	106.7
Trade balance	-31.6	-27.7	-30.7	-34.9	-50.3

Source: European Commission

It is perhaps not surprising that the EU and Russia have put economic integration at the heart of their efforts to build a stronger partnership. Ever since the early 1990s, the two

¹ Katinka Barysch, 'The EU and Russia: Strategic partners or squabbling neighbours?', Centre for European Reform, May 2004.

sides have been talking about building a 'common economic space' (CES).² The basic idea is to give Russia improved access to the EU's single market, provided that Russia brings its standards and regulations in line with the *acquis communautaire* (the EU's accumulated rulebook).

In 2001, the two sides set up a high-level group to lead the process and a team of economists set to work to thrash out the details.³ However, when the high-level group reported to the Rome EU-Russia summit in November 2003, it still did not have a workable road map for economic integration. It only listed some guiding principles but stated that it was still too early to set concrete targets. Irrespective of these difficulties, the EU and Russia have since put the 'common spaces' concept at the heart of the attempted shift away from grand rhetoric and towards pragmatic co-operation. At their St Petersburg summit in May 2003, the EU and Russia agreed to build four 'common spaces' – in addition to economics and trade, they are now seeking closer co-operation in internal security; foreign and security policy; and science, education and culture.

It took the EU and Russia another two years to agree on a plan for filling the spaces. These so-called 'road maps' were adopted at the EU-Russia summit in Moscow in May 2005. Although the 52-page document lists hundreds of possible measures and institutions, it contains few concrete project proposals and no deadlines. One expert therefore describes it as "another exercise in a reasonably courteous management of ambiguity".⁴

Under the four common spaces agreement, the concept of the CES was expanded to include energy (dealt with elsewhere in this volume). But at its core remain measures to facilitate trade and investment, and help Russia to 'converge' towards EU regulatory norms and standards. However, although the EU and Russia have now been talking about legal approximation and harmonisation for almost a decade, they have made remarkably little progress.

Box: The road map for the CES

A selection of possible measures to be adopted for building a common economic space between the EU and Russia:

- **Regulatory convergence**, for example in telecoms, automotive, pharmaceuticals; EU and Russia to set up a regulatory dialogue and increase transparency; establish where there is scope for harmonising laws; similar on financial services
- **Public procurement**: Russia to take over EU best practice on public tenders; establishment of a dialogue
- **IPR**: Establishment of a dialogue on the protection of intellectual property rights; Russia to learn from EU experience with enforcing IPR rules
- **Competition**: Russia to approximate its rules on competition policy with those of the EU and strengthen their implementation and enforcement; including rules on industrial subsidies (state aid)

² The Partnership and Co-operation Agreement, signed in 1994 and in force since 1997, stipulates that "Russia shall endeavour to ensure that its legislation will be gradually made compatible with that of the Community. The term 'common European economic space' first appeared in the EU's Common Strategy of 1999.

³ Russian-European Centre for Economic Policy, *Common Economic Space: Prospects of Russia-EU relations*. Tacis, 2002.

⁴ Michael Emerson, 'Four common spaces and the proliferation of the fuzzy', Policy brief 71, Centre for European Policy Studies, May 2005.

- **Investment:** Russia to improve the transparency and predictability of its investment climate; more systematic dialogue with the EU on investment regulations, including prior notification of changes and impact assessment; strengthen role of business in this area; Russia to ensure better implementation of rules across all regions; EU and Russia to explore the possibility of an agreement on investment-related issues
- **Economic and industrial policies:** dialogue on how internal investment conditions can be improved, especially for SME; sectoral dialogues on cars, textiles, aerospace, mining and metals, chemicals, etc
- **Agriculture:** approximation of food standards; EU and Russia to seek veterinary agreement or at least work harder to avoid trade disputes
- **Trade and customs:** use compatible computer systems; harmonise rules for example on risk assessment; build up capacity in Russian customs administration with EU technical assistance

Until 2005, the EU and Russia were very much focused on reaching a bilateral deal for Russia's accession to the World Trade Organisation (WTO), and they had little time and energy for working on the CES. But even after the bilateral deal was struck in May 2005, the EU has struggled to get Russia interested in the kind of legal approximation that underlies the CES.

Many economists, both from Russia and the EU, are sceptical about the whole idea of the CES. They say that the gap between the EU's well developed and densely regulated market and Russia's shaky, oil-dependent transition economy is so wide as to make the CES meaningless as a framework for concrete policy measures. Russian experts insist that that only a small part of the *acquis* – notably the free movement of goods, services, capital and people – would be good for Russia's development. Other EU rules, for example environmental and social standards, could harm Russia's growth prospects. Most of the *acquis* would be either irrelevant or have little impact.⁵

The European Commission has reassured Russia repeatedly that it would not have to take over the whole *acquis*. But some EU member-states fear that Russia will 'cherry pick' those parts of the *acquis* that it likes but reject those that are difficult, restrictive or expensive. Such a selective approach, they fear, could give Russia an unfair advantage.

Most importantly perhaps, the CES concept is politically flawed. Countries that want to join the EU have a strong incentive to take over EU rules and regulations, irrespective of whether they suit them or not. Russia, however, has no intention of joining the EU and the EU has not invited Russia to do so. Therefore, the CES would ultimately require Russia to play according to rules the development of which it cannot influence.

The basic idea is thus similar to that underlying the European Economic Area (EEA).⁶ The EEA gives non-EU members such as Norway and Iceland full access to the EU single market. In return, these countries implement the *acquis* in all relevant areas. Although the EU consults EEA countries in the law-making process, it does not give them a say when it decides on new rules. This asymmetry has led many former EEA members to apply for EU membership, including Sweden Finland and Austria. Norway and Iceland have their own problems with the EEA model.

⁵ Vladimir Mau and Vadim Novikov, *Otnosheiya Rossii i ES: Prostranstvo Vybor ili Vyor Prostranstva?*, *Voprosy ekonomiki* 6, 2002. Peka Sutela, 'EU, Russia and the common economic space', *Bofit online*, number 3 2005.

⁶ Tim Gold, *The European Economic Area as a model for the wider Europe*. Background paper for the EFTA parliamentary meeting, June 2003.

Given that Russians are more prickly about sovereignty than say, Norwegians, anything resembling the EEA model would be very difficult to accept. What is more, past plans for the CES would not even have allowed Russia the consultative role that the EEA countries enjoy.⁷ Russian officials and politicians made it clear from the beginning that they dislike the idea of having to unilaterally adapt to EU rules. Instead, they have been calling for a more “balanced” approach to legal approximation in which both sides converge towards each other and new rules involve mutual consultation. In recent years, that stance has hardened. Many in Russia say that the CES idea was born at a time when Russia was weak. Now that the Russian economy is booming and political stability has been restored, Russia wants to establish a more “equal partnership”. This appears to be Russia’s main objectives for the forthcoming negotiations on a new agreement with the EU to replace the 1997 Partnership and Co-operation Agreement (PCA).⁸

EU officials, on the other hand, remain adamant that non-members cannot be part of EU internal decision-making. And they point out that the *acquis* is a complex body of law that has grown over decades and often embodies delicate compromises among the EU member countries. It also often embodies international best practice and has served the EU well in building a well-functioning internal markets. In short, the EU cannot and will not adjust its laws to Russia. The process would be one-sided or not at all.

The way forward?

Perhaps realising that regulatory convergence is not the most promising way forward, the EU in July 2006 suggested that it could open talks on a free trade agreement (FTA), as part of the negotiations on a post-PCA agreement. So far, however, Russia has not shown that much enthusiasm for the idea. Russia may suspect that the EU could link the offer of free trade to demands to make the Russian energy sector more open and competitive.

However, at present, the FTA ‘carrot’ simply does not look juicy enough for Russia to compromise on vital questions such as energy sector reform or third-party access to pipelines. It is true that exports to the EU account for 15-20 per cent of Russian GDP. But most of this consists of energy and other raw materials which are hardly affected by EU trade policy. The EU, on the other hand, sells Russia machinery, cars, chemicals, consumer goods and foodstuffs. But for the EU, Russia remains a market of secondary importance: in 2005 Russia accounted for only 5 per cent of total EU external exports. Moreover, both sides have always insisted that talking about a free trade agreement would only make sense once Russia has actually joined the WTO. However, the accession process is taking longer than most observers had expected⁹, as Moscow struggles to reach a bilateral deal with Washington against the backdrop of a chillier Russia-US relationship. In September, Igor Shuvalov, a senior Putin adviser, even suggested that Russia may walk away from the WTO talks unless the US softens its demands.

⁷ Marius Vahl, *Whither the CEES? Political and institutional aspects of closer integration between the EU and Russia*, in T. de Wilde and L. Spetschinsky (ed.), *La politique étrangère de la Russie et ses implications pour l’Europe*, P.I.E.-Peter Lang, 2004

⁸ Michael Emerson, Fabrizio Tassinari and Marius Vahl: ‘A new agreement between the EU and Russia: Why, what and when?’ CEPS policy brief no. 103, May 2006.

⁹ Katinka Barysch, Pascal Lamy, Maxim Medvedkov and others, ‘Russia and the WTO’, Centre for European Reform, December 2002.

Composition of EU-Russian trade, € billion, 2005

	EU exports to Russia		EU imports from Russia	
	€ bn	% of total	€ bn	% of total
Machinery	20.8	36.9	0.7	0.7
Transport equipment	5.7	10.1	0.5	0.5
Chemicals	8.2	14.5	3.5	3.2
Farm products	8.0	8.8	2.4	2.3
Oil & gas	0.3	0.6	68.7	64.4
Textiles and clothing	2.6	4.6	0.2	0.2

Source: European Commission.

In line with Russia's current specialisation, the Putin administration now concentrates on seeking 'security of demand' for its oil and gas sales, rather than securing better market access for its manufactured goods. This choice of priorities is as rational as it is short-sighted. The Russian economy is doing well on the back of the current oil boom. But it is becoming dangerously exposed to the vagaries of the international commodities market. Not only export revenues, but also the state budget and investment spending are intimately linked with international oil prices. Resource dependent economies are not only unstable, they also tend to be badly run as the huge revenues available from oil exports foster cronyism, crime and corruption. Between 2004 and 2005 Russia dropped from 90th to 126th place (on a list of 156 countries in the Corruption Index) and now ranks alongside Niger, Sierra Leone and Albania.

Conclusion

President Putin and his team are very aware of these problems. The government has launched a series of initiatives aimed at diversifying the economy away from hydrocarbons and fighting widespread corruption. During his first term, Putin tried to clean up Russia's regulations and licensing procedures to make life easier for businesses – especially smaller ones – and remove opportunities for bribe-taking. More recently, the Kremlin is setting up a number of 'special economic zones' to attract foreign and domestic investment into high-tech ventures. The preparations for WTO entry have also entailed some valuable changes, for example a simplification customs procedures.

It appears that the Russian government knows what is required to make the economy more open, competitive and transparent. So there might be an opportunity for the EU to 'sell' the CES to Russia as being in Russia's own best interest. It could help the development of the non-oil sector and generally create a better business environment. If more Russian goods were produced in accordance with EU requirements (for example food or safety standards) they could be more easily sold to EU countries. The EU would also 'reward' reform progress in Russia with removing remaining restrictions on Russian non-oil exports. EU rules often represent international best practice, so they are better suited for a modern market economy than Russia's complex, often outdated and at times contradictory legal base. EU rules for say, competition policy and public procurement could help to establish a level-playing field in an economy where large, well-connected companies still too often stifle smaller, nimbler competitors. In short, regulatory convergence could help Russia's attempt to diversify its economy away from oil and gas. Russia needs to understand that the CES is not a burdensome EU demand but an opportunity for its own economic development.