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**Panel: ”Beyond Energy: What Does Russia Need from the EU?”**

**“The scope for EU policymaking to shape a new, institutionalized economic relationship with Russia”**

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I am pleased and honoured to be part of this panel discussion. As part of our panel, I was asked by Carnegie to make some comments on “the scope for EU policymaking to shape a new, institutionalized economic relationship with Russia”. The core message of my speech is that there is hardly any scope for this, especially as long as the EU’s energy markets are not reformed and unified. Any potential future agreement with the EU should include strong dispute settlement provisions on investment, including energy.

What does the EU want to achieve with Russia on the commercial front?

* + Better market access for exports through lower tariffs
  + Investment into Russian services (incl. energy) and manufacturing
  + Generally a predictable, non-discriminatory treatment based on international norms for both exporters and investors
  + Energy security.

We all agree on this panel that Russia would benefit from this. Protectionism and economic nationalism do not serve Russia well. And the EU has many competitive sectors from which Russia could learn.

The EU’s traditional approach to post-Soviet Russia is based on the idea that it can transform Russia by having adopt much of its own policy model. The main tool the EU uses are rules-intensive bilateral agreements. This is what the Partnership and Cooperation Agreement (PCA) of 1994 was about. But it was a simple diplomatic document with no legal bite. It was ineffective. It expired in 2007. Moves to replace it with a Strategic Partnership Agreement based on Four Common Spaces – including an economic and trade space - have not materialised so far. This is for obvious political reasons. Another reason, on the economic front, is that the EU does not want to conclude a trade agreement if Russia does not join the WTO first. It also wants Russia to respect basic Energy Charter Treaty rules. The EU hopes that the current modernisation programme of Russia and the government’s recent overtures to foreign investors will translate into concrete engagement with Europe.

But one must be aware that the recent economic crisis has not altered the political economy in Russia. On the contrary, it has revealed the resilience of the system established under Vladimir Putin’s rule. This system involves greater state monopolisation of the economy, control of the energy sector, a move to more protectionism and the use of energy as a foreign policy tool. The Reserve Fund established by the authorities to capture revenue from oil and gas has helped stabilise the economy. But it has also been used to keep the government afloat and to bail out the oligarchs that support it, along with not so competitive corporations in banking, automotive, transport that belong to them. The fundamentals of the regime remain untouched. Gazprom for example has seen no reform, and still pursues policies that mix rent-seeking with political ambitions. One such example is the project to merge with Ukraine’s Naftohaz.

Russia has average tariffs rates are higher than comparable emerging economies. According to the latest WTO data, its average trade weighted applied tariff is 11.4 per cent, higher than say Brazil’s 8.6, India’s 9.3, and China’s 4.5 Its score on indicators on “trading across borders” in World Bank indicators is very low – 162nd, on part with many African economies. Russian scores on OECD restrictiveness indexes on foreign direct investment in services is high too. Its business environment is also a bit too complicated for the country that is the richest amongst the so-called BRIC economies. A lot of these issues can be resolved with Russia’s WTO accession. Some services and regulation issues could be resolved with an FTA with the EU. Others simply require domestic reforms.

WTO accession and ideally ECT accession, would also discipline Russia’s use of trade instruments and of energy in its geopolitical actions. To name a few examples: the trade embargo on Georgia in 2006. The removal of trade preferences to Ukraine, a ban on US poultry, and the closure the border to truck transporting goods at the Turkish border, after the Georgian war in 2008.All these countries had expressed disagreement with the war. The now resolved ban on Polish meat was also part of a package to express disagreement with Poland’s opposition on the Nord Stream pipeline.

Russia’s attempts to revive its customs union with Belarus and Kazakhstan are a dilution of the issue of WTO accession. The project is not necessarily an economically sound one. CIS members trade too much with each other. All members need to plug into the rest of the world, not into each other’s rather uncompetitive markets. Some say the project is a sweet deal for Russian producers of cars, dairy and metals. The customs union is also a means for Russia to continue to exert influence over its closest clients. The United States have quite rightly raised concerns that the customs union might not be consistent with WTO rules on regional agreements.

Russia pulled out of the Energy Charter Treaty in 2009. The reason is a court case under the brought there by former Yukos shareholders. The tribunal ruled that even if Russia had not yet ratified the Treaty, it was nonetheless bound by it. Indeed, the text contains obligations to apply it provisionally, even before formal ratification.

WTO rules, ECT rules, EU FTAs, all demand a substantial dent to national sovereignty in the field of trade – so the reason for Russia to accept the rules of the game must be compelling. There must be real change at home that favours economic reforms. Let me compare Russia with China here. China, like Russia, is not exactly keen on letting its policies be dictated by multilateral institutions. However, it has accepted to abide by (at least most) WTO rules. The reason is that China’s regime survival depends on strong economic growth, and in China economic growth depends a lot on exporting cheap labour-intensive manufactures. China needs the WTO to maximise its exports.

In Russia the calculus is different. Russia faces no barriers to speak of to its main export. And it exerts quite a lot of power in the way it organises its hydrocarbons exports. Why bother with WTO or ECT? WTO induced economic reform could disturb the country’s current internal power balance. And if Energy Charter rules applied in Russia, Gazprom’s pre-eminence and the Yukos nationalisation could be questioned. This is too regime-threatening.

All this does not bode well for the EU’s endeavours with Russia.

In such a context, what can the EU do?

Unless there is a substantial shift in policy in Russia, the EU will only be able to start talking to it seriously unless it achieves on thing: its Single Market in gas. Russia has been holding sway over Europe with threats of and actual energy supply cuts. This is not so much because of an EU-wide over-dependency on Russian hydrocarbons. Russia only accounts for about one third of the EU’s gas imports. The problem is the fragmentation of the EU’s gas markets. There are different levels of dependency on imports of gas from Russia, different levels of collaboration with Gazprom and other Russian majors. This leads to strong divisions as to Russia’s energy policies towards the EU. Only a single market in gas will bring an end to this self-defeating dynamic in the EU.

I will pass on the details of the last 2009 Energy Package. But fundamentally, Brussels has failed to make member states fully dismantle their gas monopolies. The member states that need gas market reform most, namely the Central and Eastern European ones, are those that have been most exempted from market-based EU rules. The competition authorities in Brussels have launched widely publicised antitrust cases against the energy majors in France, Germany and Italy. This is because their monopolies over pipelines have led them to restrict investment, with the effect that capacity to import was reduced. This threatens supply security. Such antitrust actions have not been seen yet in Central and Eastern Europe. These would help these countries reduce their overdependency on one single gas supplier. Action here is more than welcome.

Only if the EU starts applying as systematically as it should many of the market and regulation principles it professes to Russia in the energy field, only then Russia will start taking the EU more seriously. Russia and Gazprom have been weakened in the recent crisis. Now is the moment to clean up Europe’s gas markets.

To conclude, back to EU Strategic Partnership discussions with Russia. If they ever get down to substance – then I would say that the EU would need to insist on strong dispute settlement provisions for trade and investment and include of course energy markets in these provisions. This should be a precondition to any further discussion , after Russia accedes to the WTO. With the Lisbon Treaty, the Commission’s DG Trade has new powers to do so. This is a challenge to Russia. But Russia would gain too – it would give more credibility to the current Russian overtures, provide a better investment climate at home, but also depoliticise Russia’s own investments in the EU.