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# CASE Network Studies & Analyses

## Economic Relations between the EU and CIS (An Overview)

**Marek Dabrowski**

No. 352/2007

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## **Abstract**

The purpose of this paper is to examine the economic aspects of EU policy towards its Eastern neighbors in the former Soviet Union. For a long period of time, this region was considered as less important for the EU, as compared to Central and Eastern Europe, which was the subject of a far-reaching economic and political integration offer materialized in two rounds of EU Eastern Enlargements (2004, 2007). However, moving the EU's geographical frontier further to the East and Southeast increased the importance of the CIS region as a potential partner of the enlarged EU. In 2004, East European and Caucasus countries were invited to participate in the European Neighborhood Policy a new EU external policy framework also addressed to the Southern Mediterranean countries. Russia has been attempting to build a strategic political and economic partnership with the EU outside the ENP framework but the content of this relationship is, in fact, very similar to the ENP.

A general weakness of the ENP is that there is a lack of balance between far-reaching expectations with respect to neighbors' policies and reforms, and limited and distant rewards that can potentially be offered. Thus, making this cooperation framework more effective requires a serious enhancement of the rewards using, to the extent possible, the positive experience of previous EU enlargements. The nature of contemporary economic relations in the globalized world calls for a more complex package-type approach to economic integration rather than just limiting cooperation to some narrow fields.

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## Introduction

The purpose of this paper<sup>1</sup> is to examine the economic aspects of the EU policy towards its Eastern neighbors. We are going to make a general overview of bilateral relations between the enlarged EU and CIS countries in the spheres of trade, investment, labor movement, technical cooperation, and influence of the EU's economic and institutional model on the course of CIS economic reforms and institutional modernization. Obviously, the issues mentioned above cannot be fully separated from the political context and political agenda – domestic, bilateral and multilateral. However, our analysis will concentrate on economic cooperation and its impact on economic reforms in CIS countries and will refer to political developments only to the extent justified by their direct impact on economic developments.

We use the name of the Commonwealth of Independent States and its abbreviation CIS purely for analytical convenience – to define a group of twelve successor countries of the former USSR (all former Soviet republics apart from the Baltic states, which are now EU members). Although these twelve countries have, to a large extent, a common historical and institutional background (at least throughout most of the 20<sup>th</sup> century) their development strategies, as well as political and economic systems, have become increasingly divergent from one another after gaining independence. We are also aware that the role of the CIS as a regional integration block, founded at the end of 1991 in order to provide a “velvet divorcement” of the former USSR, is gradually decreasing<sup>2</sup>.

This paper briefly summarizes the early results of the Specific Targeted Research Project (STREP) on “EU Eastern Neighborhood: Economic Potential and Future Development (ENEPO)” funded under the EU Sixth Framework Program, Priority 7 “Citizens and Governance in a Knowledge Based Society”, Contract No 028736 (CIT5) and conducted by a consortium of 11 research institutes led by CASE – Center for Social and Economic Research in Warsaw.

Section 1 of this paper characterizes the economic importance of both regions in their bilateral economic relations. Section 2 examines EU-CIS trade and economic relations before the EU Eastern Enlargement. Section 3 analyses the basic conceptual

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<sup>1</sup> This is a revised and substantially amended version of my paper on “Perspectives of EU-CIS economic relations” presented at the VIII Annual International Conference of the High School of Economics on “Economic Modernization and Social Development”, Moscow, April 3-5, 2007. The original (shorter) version of my paper will be published in the post-Conference proceedings. I would like to thank Elizabeth Rivard for her excellent editorial support.

<sup>2</sup> This group of countries is at times referred to as the New Independent States (NIS). However, as more than 15 years have passed since the end of 1991 when they obtained independence, this notion also does not sound accurate. The ambitious task of finding a more appropriate name of this regional group is outside the agenda of this paper.



foundations of the European Neighborhood Policy, the new external policy framework of the enlarged EU. Section 4 provides a brief note on the special partnership between the EU and Russia. In section 5, we discuss possible directions in enhancing and upgrading the ENP and EU-CIS economic relations. Finally, Section 6 offers brief conclusions.

# **1. Geopolitical and economic importance of the CIS region for the EU and vice versa**

The 2004 and 2007 EU enlargements moved the EU external borders to the East and Southeast, radically altering the EU's geopolitical and economic perception of the CIS region and its potential importance as an economic and political partner.

Until these enlargements, CIS countries formed the second, outer 'ring' of the EU neighbors, being geographically separated from the EU by the EU accession countries of Central and Eastern Europe. Their economic and political importance for the EU-15 was quite limited with the exception of Russia, the largest (territorially) country in the world with huge natural resources and nuclear weapons, directly bordering one of the EU members (Finland).

To simplify, the EU-15 real economic and foreign policy interests in cooperation with CIS countries concentrated primarily on oil and natural gas supply from Russia, and on relative geopolitical stability of the post-Soviet area (avoiding proliferation of regional and ethnic conflicts).

The picture changed with the Eastern Enlargement of the EU. First, in purely geographical terms four CIS countries – Russia, Ukraine, Belarus and Moldova – became the direct EU neighbors sharing long land borders. In a slightly longer time horizon, with Turkey's accession, three Caucasian countries (Armenia, Azerbaijan and Georgia) will also share their land borders with the EU. Already they share the Black Sea with the enlarged EU. It means that all but Central Asian CIS countries have already moved, or will move, geographically from the second to the first ring of EU neighbors.

Most of the new members states (NMS) of the EU have a political and economic history similar to the countries of the former USSR, not only due to the unfortunate communist experience of the second half of the 20<sup>th</sup> century; some of them were part of the Russian empire (part of Poland, Baltic countries, Finland) before World War I. There are close ethnic and cultural links between NMS and EU candidate countries on the one hand and CIS countries on the other (Romania – Moldova, Poland – Belarus and Ukraine, Russian speaking minority in Baltic countries, Turkey – Azerbaijan and most of post-Soviet Central Asia).

Looking at the aggregate trade indicators, the importance of the CIS for the EU-27 is not much higher than it was for the EU-15. This is a result of the limited economic potential of both NMS and CIS. In 2003, the NMS-10 constituted only 4.7% of EU-25 total GDP and a small share of its total extra-EU export. On the other hand, even including Russia, the overall CIS share in the world economy is quite limited. It

accounted for 3.7% of world GDP in 2003 (PPP-based estimation) and 2.3% of global exports (see WEO, 2004; Table A).

According to the European Economy (2005) only 2.2% of the total exports of the EU-25 in 2004 was directed to the CIS (see **Table 1**). For comparison, another EU 'neighborhood' region – the Middle East and North Africa (MENA) accounted for only a slightly higher share of EU-25 countries' exports – 3.8% on average. In CIS countries the shares of EU exports as part of their total exports are higher, at times much higher, than the share of EU exports to the region, as illustrated by **Table 2**. Such an asymmetry can be considered as normal when less-developed or middle-income countries representing a limited economic potential<sup>3</sup> trade with a large developed partner or a large and highly integrated trade block.

However, the aggregate and average statistics presented in **Table 1** may be misleading, for at least three reasons.

First, the concept of EU-25 exports in this table also includes intra-Union trade, which accounts for 68.3% of the total (even slightly more if Bulgaria and Romania are

**Table 1. Directions of Exports of Goods, 2004, World = 100%**

	EU-25	Acceding/ Candidate Countries	CIS	MENA
<b>EU-25</b>	68.3	2.4	2.2	3.8
<b>Belgium</b>	77.8	1.3	0.9	3.1
<b>Czech Republic</b>	83.8	3.0	2.4	1.6
<b>Denmark</b>	68.5	1.0	1.8	2.5
<b>Germany</b>	64.6	2.7	2.8	3.0
<b>Estonia</b>	74.6	0.6	11.5	0.5
<b>Greece</b>	60.1	15.6	3.3	7.0
<b>Spain</b>	75.2	2.5	0.9	5.2
<b>France</b>	67.1	2.0	1.4	6.8
<b>Ireland</b>	63.2	0.5	0.3	1.3
<b>Italy</b>	60.4	4.8	2.6	6.3
<b>Cyprus</b>	64.9	2.8	2.8	17.6
<b>Latvia</b>	75.9	0.1	7.8	1.0
<b>Lithuania</b>	61.3	2.1	15.2	0.1
<b>Luxembourg</b>	90.4	0.7	0.8	1.0
<b>Hungary</b>	80.7	6.0	3.2	2.2
<b>Malta</b>	44.5	2.4	0.1	5.2
<b>Netherlands</b>	81.0	1.4	1.6	2.3
<b>Austria</b>	72.4	4.2	2.4	1.8
<b>Poland</b>	79.1	3.1	7.9	1.2
<b>Portugal</b>	80.8	0.9	0.3	1.8
<b>Slovenia</b>	73.3	11.1	5.1	2.1
<b>Slovakia</b>	85.7	2.9	2.8	0.5
<b>Finland</b>	58.3	1.1	9.9	4.7
<b>Sweden</b>	59.1	1.3	2.1	3.2
<b>United Kingdom</b>	57.0	1.6	1.3	5.0

Source: European Economy 2005, No. 5, Table 57

<sup>3</sup> This characteristic also applies to Russia in spite of its large territory and geopolitical importance. The total nominal size of Russia's 2005 GDP of USD 763 billion (calculated using the current exchange rate) is close to that of Australia (USD 709 billion), Mexico (USD 768 billion), India (USD 772 billion), Korea (USD 778 billion) and Brazil (USD 796 billion) - WEO 09\_2006 database <http://www.imf.org/external/pubs/ft/weo/2006/02/data/index.aspx>

**Table 2. Share of exports to EU-25 as a proportion of a country's total exports**

Country	2004
Armenia	38.2
Azerbaijan	65.2
Belarus	37.0
Georgia	30.1
Kazakhstan	31.7
Kyrgyzstan	4.9
Moldova	38.3
Russia	50.4
Tajikistan	32.4
Ukraine	27.4
Uzbekistan	17.4

Source: ENEPO WP1 database; UNCTAD Statistical Handbook 2005.  
<http://stats.unctad.org/Handbook/ReportFolders/ReportFolders.aspx>

included). Thus, when analyzing the structure of EU external trade, the shares of non-EU countries/ regions should be tripled, at least.

Second, **Table 1** demonstrates that some of the EU member countries represent higher shares of trade with the CIS than the EU average. This relates to the three Baltic countries, Poland, Finland, Bulgaria and Slovenia. Consequently, these countries can gain more from development of EU-CIS trade relations. However, they are also more vulnerable *vis a vis* any potential episodes of political, economic or social destabilization in the CIS<sup>4</sup>.

CIS countries also differ among themselves in terms of the importance of their trade relations with the EU (see **Table 2**). In 2004, the share of exports to the EU as part of a country's total exports varied from 4.9% in Kyrgyzstan to 65.2% in Azerbaijan. Russia is second in this ranking with a share of 50.4%. However, in most cases, the high share of exports to the EU is determined by just one commodity/ group of commodities: energy resources in the cases of Azerbaijan, Kazakhstan and Russia, aluminum in Tajikistan, diamonds in Armenia, and metal products in Ukraine. The monoculture structure of CIS countries' exports can be considered as a serious source of their potential vulnerability to external shocks.

Third, the special importance of the energy sector also must be taken into account. Many EU countries are very much dependent on imports of CIS energy resources from Russia and, to a smaller but systematically increasing extent, also from the

<sup>4</sup> At the beginning of the 1990s, the former CMEA countries and Finland had been heavily affected by a disruption of this trade block (based on inter-government trade protocols and a special payment mechanism) and the collapse of the USSR. The next shock originating from the CIS region - the 1998 Russian and CIS financial crisis - had a less severe and more differentiated impact. Although Central European and Baltic countries managed to avoid a direct contagion effect with respect to their currencies and financial markets (unlike most CIS countries), some of them suffered substantial export and GDP losses. This relates, in the first instance, to Baltic countries and (to lesser extent) to Poland and Bulgaria.

Caspian Sea region. In 2004, Russia supplied approximately 40% of all EU gas imports, 32% of all EU oil imports and around 17% of coal imports (Eurostat, 2006). Individual EU countries represent even higher dependence on energy imports from the CIS, particularly from Russia. For example, in 2004, imported Russian gas accounted for more than 80% of all gas consumed in the Czech Republic, Finland, Greece, Lithuania and Slovakia (see Jakubiak and Paczynski, 2007). Likewise, energy export plays a crucial role in countries such as Azerbaijan (around 90% of total exports), Russia, Kazakhstan, Turkmenistan and, to a lesser extent, Uzbekistan.

Going beyond trade in goods and services, labor migration from the CIS to the EU represents another potentially important field of economic cooperation. In spite of restrictive migration and visa policies in the EU, the flow of labor migrants (primarily irregular or illegal migrants) from European CIS countries to the EU is systematically increasing.

As in the case of trade flows, migration has an asymmetric impact on both sides and their importance differs country by country. For the EU as a whole, the immigrants of CIS origin still constitute a small share of a total migrant inflows (in spite of their systematically growing number) and the labor force, much smaller than intra-EU flows (particularly from the EU NMS to OMS) or migration from the Middle East, Africa and Asia. However, migration flows from the CIS are unevenly distributed between EU member countries, with the majority of migrants settling in NMS and Mediterranean countries<sup>5</sup>.

Considering the “export” side, outgoing migration has become a serious economic and social phenomenon for some low-income CIS countries where one quarter to one third of the population of working age works abroad, at least on a seasonal basis – in Russia, the EU, Turkey and other countries (Kazakhstan in the case of Central Asian migrants). Emigrants’ remittances constitute a substantial portion of GNP and an important balance-of-payment item. In the case of Moldova, the outflow of the labor force amounts to approximately one quarter of the working-age population, and remittances accounted for one third of GNP in 2006 (see Luecke, 2007). According to the same research, remittances amounted to 14% of GNP in Georgia and 17% in Kyrgyzstan. Other sources differ in terms of exact figures (see **Table 3** based on the UNCTAD database), which is hardly surprising taking into consideration the unofficial character of labor migration and various channels of transferring remittances to one’s home country (primarily outside the formal banking sector).

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<sup>5</sup> Factors of geographical, cultural and language proximity play an important role here. Ukrainian labor migrants prefer, for example, countries of Central Europe such as the Czech Republic, Poland or Slovakia (but many of them also work in Spain or Portugal), while Moldovan migrants often choose countries with a Romance language as the official language.

**Table 3. Labor remittances as %of GDP**

Country	2004
Armenia	14.11
Azerbaijan	3.59
Belarus	0.53
Georgia	7.08
Kazakhstan	0.19
Kyrgyzstan	8.66
Moldova	38.83
Russia	0.48
Tajikistan	15.40
Ukraine	0.75

Note: Workers' remittances are goods and financial instruments transferred by migrants living and working (as residents) in a new economy to residents of the home economy.

Source: ENEPO WP1 database; UNCTAD Statistical Handbook 2005.

<http://stats.unctad.org/Handbook/ReportFolders/ReportFolders.aspx>

Finally, capital flows are important for CIS countries as the potential importers of capital and at times exporters as well, due to capital flight. For the EU economies, the size of capital movement between them and the CIS represents a negligible scale.

For many years CIS countries lagged behind countries of Central and Eastern Europe in attracting foreign direct investment (FDI). This was mainly due to the poor business and investment climate in this region caused by high inflation, high fiscal deficits, currency instability, poor protection of property rights, insider-oriented privatization, numerous bureaucratic obstacles (including those directly affecting foreign investors), delays in adopting market-oriented legislation and its effective enforcement, pervasive corruption, a fragile financial sector, and underdeveloped infrastructure, for example. A substantial part of recorded FDI had, in fact, post-Soviet origin even if it was formally recorded as originating in other countries (repatriation of capital, which earlier fled CIS countries). Most investments were concentrated in only a few sectors such as energy or mobile telephony.

The situation began to change quite recently, in the mid-2000s, with rapid capital inflows to the largest CIS economies such as Russia, Ukraine and Kazakhstan. Their sectoral destination is much broader than before, including various manufacturing industries, retail trade, financial services, etc. Also, this FDI is accompanied by increasing portfolio capital flows (see Lozovyi and Kudina, 2007).

On the other hand, some smaller CIS economies managed to increase FDI flows either due to investment in the energy sector (Azerbaijan), or as a result of privatization and some improvement in the investment climate (Armenia, Georgia and Moldova). However, CIS countries continue to experience a substantial gap in the size of FDI flows, not only with respect to EU NMS, but also to countries of Southeastern Europe (see **Table 4**).

Table 4: Foreign direct investment, inward stock, 2005

Countries	Per capita in USD	% of GDP
<b>EU NMS</b>		
Bulgaria	1185.0	34.3
Cyprus	10496.7	52.7
Czech Republic	5831.4	48.1
Estonia	9125.9	93.6
Hungary	6068.7	55.9
Latvia	2079.5	28.7
Lithuania	1891.9	25.1
Malta	10380.8	77.3
Poland	2445.4	31.1
Romania	1101.0	24.2
Slovakia	2844.5	32.8
Slovenia	4035.9	23.7
<b>EU Candidate countries</b>		
Croatia	2816.0	33.3
Macedonia	924.3	37.5
Turkey	580.6	11.6
<b>EU Potential candidates</b>		
Albania	536.9	20.1
Bosnia and Herzegovina	528.9	21.9
Serbia and Montenegro	664.6	20.7
<b>CIS countries</b>		
Armenia	406.1	32.5
Azerbaijan	1689.9	110.5
Belarus	243.7	8.1
Georgia	518.4	36.3
Kazakhstan	1660.6	44.8
Kyrgyzstan	101.2	21.4
Moldova	268.4	37.9
Russia	925.5	17.3
Tajikistan	80.2	22.6
Ukraine	365.3	21.1
Uzbekistan	36.2	8.2

Source: ENEPO WP1 Database; UNCTAD Foreign Direct Investment database (<http://stats.unctad.org/fdi/>); UNCTAD World Investment Report 2006.

## 2. EU – CIS economic relations before the EU Eastern Enlargement

Cooperation between the EU-15 and new independent states of the former USSR was built on the basis of bilateral Partnership and Cooperation Agreements (PCA) negotiated during the 1990s. Nine of them entered in force between 1997 and 1999, after a lengthy ratification process, (see **Table 5**). The PCA with Belarus was signed in March 1995 and PCA with Turkmenistan in May 1998; yet, to date, neither has entered into force due to political reasons. The PCA with Tajikistan was signed in October 2004 but the ratification process has yet to finish.

**Table 5. Partnership and Cooperation Agreements between EU and CIS Countries**

Country	Entered in force
Armenia	1.07.1999
Azerbaijan	1.07.1999
Georgia	1.07.1999
Kazakhstan	1.07.1999
Kyrgyzstan	1.07.1999
Moldova	1.07.1998
Russia	1.12.1997
Ukraine	1.03.1998
Uzbekistan	1.07.1999

Source: [http://ec.europa.eu/external\\_relations/ceeca/pca/index.htm](http://ec.europa.eu/external_relations/ceeca/pca/index.htm)

The PCAs offered very little in the area of economic integration: the Most Favored Nation (MFN) clause, some sectoral, legal and institutional cooperation in such areas as transportation, energy, competition policy, some legal approximation in the areas of custom law, corporate law, banking law, intellectual property rights, technical standards and certification, etc.<sup>6</sup> However, dialogue and cooperation in the area of legal and institutional approximation was lacking both sufficient incentives and an enforcement mechanism.

This differed from the agenda and implementation mechanism of the Trade and Association Agreements (TAA) signed by the EEC/EU with Central European and Baltic countries at the beginning and middle of the 1990s, as well as the Stabilization and Association Agreements (SAA) negotiated with Western Balkan countries in the 2000s. Both TAAs and SAAs were aimed at building “deep” free trade areas, and

<sup>6</sup> The 2003 Commission Communication on Wider Europe (see Section 3 of this paper for details) stated explicitly (p. 5): “*In contrast to contractual relations with all the EU’s other neighbouring countries, the Partnership and Cooperation Agreements (PCAs) in force with Russia, Ukraine and Moldova grant neither preferential treatment for trade, nor a timetable for regulatory approximation*”, [http://ec.europa.eu/world/enp/pdf/com03\\_104\\_en.pdf](http://ec.europa.eu/world/enp/pdf/com03_104_en.pdf).



included a broad agenda of institutional harmonization (adopting *acquis* by EU partners) and, most importantly, offered a perspective of EU membership. Some of the TAAs and SAAs were negotiated and signed simultaneously with WTO accession of the respective countries, in few cases even before the formal conclusion of the latter. This was in sharp contrast to the EU attitude to CIS countries: their WTO membership was considered by the EU as a basic precondition to start negotiating any kind of bilateral free trade agreement.

The WTO accession process of the largest CIS countries (Russia, Ukraine, Kazakhstan, excluding Belarus) went slowly so the perspective of trade liberalization between the EU and them remained distant until very recently. Furthermore, even those smaller countries – Kyrgyzstan, Moldova, Armenia and Georgia – which joined the WTO in the late 1990s or early 2000s, also did not receive any trade liberalization offer.

To have a complete picture one must admit, however, that all CIS countries could benefit, to a various degree, from the Generalized System of Preferences (GSP) offered unilaterally by the EU to less developed countries<sup>7</sup>. These are primarily preferential import tariffs.

From the very beginning of their independence, CIS countries also benefited from generous European aid programs delivered both by the EEC/EU as a whole and its individual member states (Light, 2007). Among these programs, TACIS (Technical Assistance to the Commonwealth of Independent States) was aimed at supporting the democratic and market transition, economic and social modernization, cross-border cooperation and solving numerous regional/ sub-regional issues.

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<sup>7</sup> See [http://ec.europa.eu/trade/issues/global/gsp/index\\_en.htm](http://ec.europa.eu/trade/issues/global/gsp/index_en.htm)

### 3. European Neighborhood Policy – A Basic Conceptual Framework

The EU attitude towards the CIS region began to change at the beginning of the 2000s. The forthcoming EU Eastern Enlargement stimulated an intra-EU debate and conceptual effort on upgrading its relations with both its Eastern and Southern neighbors. On the other hand, it reflected the notion that the CIS region is far from being homogeneous in political, economic and social terms, and CIS countries require a more individualized approach (Light, 2007).

The Communication from the Commission to the Council and the European Parliament on “Wider Europe-Neighborhood: A New Framework for Relations with our Eastern and Southern Neighbors” (of March 11, 2003)<sup>8</sup> was the first attempt to propose a new policy framework towards countries which are to become direct geographical neighbors after the then forthcoming Eastern Enlargement. This document was followed by the official launch of the European Neighborhood Policy (ENP) on May 12, 2004, less than two weeks after the first and main phase of the EU Eastern Enlargement was successfully completed.

Interestingly, the 2003 Communication on Wider Europe, which reflected the initial position of the Commission, offered a wider and more far-reaching vision of cooperation with neighbors and clearer incentives for them than the subsequent 2004 European Neighborhood Policy Strategy Paper<sup>9</sup>, which also took into account the views of the individual member states. The differences were that in the first paper, the focus was on clearer language of access to the EU internal market, perspectives of free movement of people, visa facilitation, and other potential incentives, while the Strategy Paper put more emphasis on EU security interests, fighting illegal migration, etc. (Schweickert et al., 2007).

According to the ENP Strategy Paper, the declared ENP objective was to avoid the emergence of new dividing lines between the enlarged EU and its old and new direct neighbors, as well as strengthening stability, security and well being in the entire mega-region. The EU offered its neighbors “...a *privileged relationship, building upon a mutual commitment to common values (democracy and human rights, rule of law, good governance, market economy principles and sustainable development)*. The ENP goes beyond existing relationships to offer a deeper political relationship and economic

<sup>8</sup> [http://ec.europa.eu/world/enp/pdf/com03\\_104\\_en.pdf](http://ec.europa.eu/world/enp/pdf/com03_104_en.pdf)

<sup>9</sup> [http://ec.europa.eu/world/enp/pdf/strategy/strategy\\_paper\\_en.pdf](http://ec.europa.eu/world/enp/pdf/strategy/strategy_paper_en.pdf)

*integration. The level of ambition of the relationship will depend on the extent to which these values are effectively shared*"<sup>10</sup>.

Originally this general declaration was followed by a clear statement that the ENP is not concerned with the next EU enlargements nor does it offer neighbors an EU accession perspective. At the end of 2006 it was replaced by a more flexible approach citing that *"the ENP remains distinct from the process of enlargement although it does not prejudice, for European neighbors, how their relationship with the EU may develop in future, in accordance with Treaty provisions."* In fact, this can be considered as return to both the language and spirit of the above-mentioned Communication on Wider Europe of the Commission in 2003.

As a result, the door became hypothetically opened for those CIS countries which are participants of the ENP (see below) and which will be ready to harmonize their political, economic and legal systems with *acquis*. This seems to be, however, a very distant and unclear perspective, particularly if one takes into consideration the phenomenon of "enlargement fatigue" observed recently in some countries of Western Europe. Although the anti-enlargement sentiment works particularly strongly against the EU membership aspirations of Turkey (for historical and cultural reasons), one can expect a similar reaction to the EU membership aspirations of Ukraine, Moldova or Caucasus countries when they begin to materialize.

So, if the perspective of EU membership is either very weak and distant (the case of European CIS countries) or non-existent (the case of the Southern Mediterranean neighbors), what are the alternative incentives provided by the ENP to neighboring countries to encourage them to undertake a costly modernization effort, accept the European set of values in the area of democracy, human rights and market economy, and close cooperation with the EU on security issues? The general answer is: access to the EU internal market. The ENP Strategy Paper (p.14)<sup>11</sup> offers *"... neighbouring countries the prospect of a stake in the EU Internal Market [underlined by MD] based on legislative and regulatory approximation, the participation in a number of EU programmes and improved interconnection and physical links with the EU"*. However, so far there is no clear interpretation of what *"a stake in the EU Internal Market"* means in practice.

Furthermore, taking into consideration the poorly developed institutional basis of trade and economic relations between the EU and CIS countries (based only on PCAs – see Section 2 of this paper), it is very unlikely that the ENP can offer the latter full participation in the EU internal market, similar to that of Norway, Iceland or Switzerland. A gradual building up of these relations based on more or less "deep" free trade agreements (FTA) and selective participation in some segments of the EU

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<sup>10</sup> [http://ec.europa.eu/world/enp/policy\\_en.htm](http://ec.europa.eu/world/enp/policy_en.htm)

<sup>11</sup> [http://ec.europa.eu/world/enp/pdf/strategy/strategy\\_paper\\_en.pdf](http://ec.europa.eu/world/enp/pdf/strategy/strategy_paper_en.pdf)

internal market, a process which will take at least one decade, seems to be a more realistic option at the moment.

Recent ENP official documents<sup>12</sup> put greater emphasis on the necessity to use this institutional framework as a tool of modernization and support to economic and institutional reforms in neighborhood countries. Again, concrete perspectives have yet to follow, particularly with respect to tangible incentives.

The ENP is conducted through bilateral Action Plans and the principle of bilateralism is deeply rooted in this policy framework, contrary to the regional approach, which governed the recent EU Eastern Enlargement. This does not mean, however, that third-country externalities of bilateral agreements will be completely ignored. For instance, some form of coordination on the EU side of future FTA negotiations with Russia and Ukraine is not excluded. Simultaneous negotiations and signing actions plans between the EU and all three Caucasus countries (in mid-November 2006) can serve as another good example of a coordinated sub-regional approach.

The ENP has covered five CIS countries to date: Armenia, Azerbaijan, Georgia, Moldova and Ukraine. All of these countries agreed and signed bilateral three-year Action Plans with the EU in 2005-2006. However, the implementation record of Action Plans for Moldova and Ukraine, which were launched at the beginning of 2005, is mixed (see Jakubiak et al., 2006 on Moldova and Jakubiak, Kolesnichenko et al., 2006 on Ukraine). Economic and institutional reforms in these two countries are going rather slowly and the lack of a clear set of external incentives and a clear cooperation timetable can be considered as one of the major reasons for this unsatisfactory performance.

Negotiations on the new EU – Ukraine Enhanced Agreement launched in March 2007<sup>13</sup> can be considered the next step in building a closer cooperation framework with this important ENP country. The new agreement will replace the PCA and may include, among other possibilities, a “deep” FTA based on the existing feasibility study (see Emerson et al., 2006). In June 2007, Ukraine also signed a visa facilitation agreement with the EU<sup>14</sup>, following a similar agreement between the EU and Russia (see Section 4).

Belarus is a potential ENP participant but it currently has a “frozen” status, for political reasons (an autocratic regime and violation of human rights); similarly, this is the case for Libya and Syria in the Mediterranean region. The EU also launched a mechanism of strategic partnership with Russia, similar to the ENP (see Section 4).

<sup>12</sup> See e.g. “Strengthening the European Neighborhood Policy. Presidency Progress Report”, General Affairs and External Relations Council (GAERC), June 18-19, 2007, <http://register.consilium.europa.eu/pdf/en/07/st10/st10874.en07.pdf>

<sup>13</sup> <http://www.europa.eu/rapid/pressReleasesAction.do?reference=IP/07/275&format=HTML&aged=0&language=en&guiLanguage=en>

<sup>14</sup> <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/849&format=HTML&aged=0&language=en&guiLanguage=en>

Five Central Asian countries have been left outside the ENP but one cannot exclude the possibility that some of them (most likely beginning with Kazakhstan) will be invited to join this cooperation framework at some point in future. During its meeting from June 21-22, 2007 in Brussels, the European Council approved the document titled "The EU and Central Asia: Strategy for a New Partnership"<sup>15</sup>, which outlines the EU strategy towards this sub-region. Its agenda is, however, narrower and less ambitious compared to the ENP.

A general weakness of the ENP is the lack of balance between far-reaching expectations in respect to neighbors' policies and reforms, and limited and distant rewards which it can potentially offer (see Schweickert et al., 2007). This imbalance is especially acute in such areas as migration policy, where the EU is looking for extensive cooperation of neighboring countries in fighting illegal migration to the EU (very often, against the interests of their own citizens), while offering very little in the realm of facilitating legal migration and freer movement of people (see Guild et al., 2007).

More generally, there is doubt as to whether the lack of a clear offer of EU membership can mobilize governments of the neighboring countries to conduct difficult and sometimes unpopular economic and institutional reforms required to align with *acquis* (Milcher, Slay and Collins, 2007). On the other hand, one may ask whether the perspective of EU membership, even if hypothetically provided, would be interesting and attractive enough for all the neighboring countries, many of them from a different historical and cultural background, and with other geopolitical and economic priorities than those shared by EU members. We will come back to this question in Section 5 of this paper.

Another controversial aspect of the ENP relates to the strictly geographical concept of this initiative addressed only to countries, which share land, Mediterranean Sea and Black Sea borders with EU members<sup>16</sup>. As a result, post-Soviet Central Asia has been left outside the ENP in spite of its close historical, economic and political links to CIS ENP countries and Russia, and its increasing economic importance for the EU as a prospective energy supplier.

In addition, combining these two very different regions under one policy framework does not necessarily make the ENP more coherent, easier to manage and able to generate regional externalities. In the short term, however, the experience of EU cooperation with the Mediterranean region under the Barcelona process, and of quite complex Association Agreements concluded between EU and individual Middle East and North Africa countries in the 1990s and early 2000s, may create a positive demonstration effect on how best to upgrade the less advanced economic cooperation between the EU and CIS countries.

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<sup>15</sup> <http://register.consilium.europa.eu/pdf/en/07/st10/st10113.en07.pdf>

<sup>16</sup> Armenia, Azerbaijan and Jordan being the exception to this rule.

## 4. Special partnership framework for Russia

In spite of an initial offer from the EU, the Government of the Russian Federation opted out of participating in the formal ENP framework, preferring to have separate, strategic partnership relations with the EU. This framework is to be built on the concept of the Common European Economic Space between the EU and Russia, as defined by joint declarations of subsequent EU-Russia summits in October 3, 2001<sup>17</sup> and May 31, 2003<sup>18</sup>. The next step involved a joint EU-Russia declaration on May 10, 2005 defining so-called road maps of four common spaces<sup>19</sup>:

- Common Economic Space (including environmental and energy issues)
- Common Space of Freedom, Security and Justice (including migration and visa issues)
- Common Space of External Security
- Common Space on Research, Education and Culture

Beginning in 2007, Russia is also a beneficiary country of the European Neighborhood Policy Instrument (ENPI), which replaced the previous aid program, TACIS.

The EU and Russia are about to commence negotiations on the new strategic cooperation agreement aimed to replace the old PCA (see Section 2) signed in 1994 and entering in force in 1997. However, details of the content of this new treaty have yet to be determined. For example, it is unclear whether it will include a free trade agreement between the EU and Russia and how “deep” this type of agreement might be.

In 2006, the EU and Russia also signed a visa facilitation agreement, which entered into force on June 1, 2007. This agreement, which is similar to the one signed by the EU and Ukraine in 2007, makes short-term travel for various categories of visitors (including business people) easier and opens the opportunity to negotiate a visa free regime in the long term.

Generally, Russia has the chance to develop a broad agenda of economic, political and institutional cooperation with the EU, comparable to that of the most advanced ENP countries (Moldova and Ukraine in Eastern Europe; Morocco and Tunisia in the Mediterranean region) or even going beyond this benchmark. Given the large size of the Russian economy and its middle income status, the key role of Russia’s energy exports in meeting EU energy demand, and the geopolitical

<sup>17</sup> [http://www.delrus.ec.europa.eu/en/images/pText\\_pict/238/sum41.doc](http://www.delrus.ec.europa.eu/en/images/pText_pict/238/sum41.doc)

<sup>18</sup> [http://www.delrus.ec.europa.eu/en/p\\_234.htm](http://www.delrus.ec.europa.eu/en/p_234.htm)

<sup>19</sup> [http://www.delrus.ec.europa.eu/en/images/pText\\_pict/494/road%20maps.pdf](http://www.delrus.ec.europa.eu/en/images/pText_pict/494/road%20maps.pdf)

importance of this country (but without EU membership aspirations at the moment), the EU may be potentially interested in closer economic integration of Russia with the EU internal market. This, in turn, could help the Russian economy to complete its market transition, and advance its modernization and diversification. However, the future of EU-Russia cooperation will depend on the speed of domestic economic and political reforms in Russia, as well as on the geopolitical interest of the latter to build closer links with the EU.

## 5. How to make the ENP effective?

The fundamental weakness of the ENP, i.e. its internal imbalance between effort needed to harmonize neighboring countries institutions with *acquis* and incentives provided (see Section 3), leads many experts to call for a serious enhancement on the “reward” side. For example, Emerson et al. (2007) propose the concept of ENP Plus, which should add the following elements to the existing ENP design:

- an advanced association model for the able and willing partner states,
- a strengthening of regional-multilateral schemes,
- upgrading of the standard instruments being deployed,
- the offer of an ‘ENP light’ model for difficult states or non-recognized entities.

Indeed, in order to have a real impact on development, modernization and reform of CIS countries, the ENP initiative must go beyond the narrowly defined cooperation agenda in some selected sectors and areas considered a priority by the EU (examples of these areas include energy supply and fighting illegal migration), as well as address a broader set of issues.

In the economic sphere, both the EU and neighboring countries must go beyond the idea of simple trade liberalization in the narrow sense (i.e. scrapping tariffs, mostly for manufactured products) towards a more complex and ambitious agenda. The contemporary global economy is much more sophisticated than it was a few decades ago and its complexity determines the need for broader liberalization (called sometimes a “deep FTA”, “enhanced FTA” or “FTA plus” – see above), also involving freer movement of services, investments and labor based on a far-reaching institutional harmonization/ alignment package. Let us take a brief look at how this web of mutually dependent policies works:

1. Trade expansion between the EU and its Eastern neighbors will depend not only on trade liberalization *per se* (first membership of all the CIS countries in the WTO, then their FTAs with the EU), but also on the investment climate in the CIS region, speed of institutional harmonization and, to some extent, on liberalization of movement of people (particularly important for trade in services).
2. Intensification of foreign investment inflow to the CIS region will depend not only on significant improvement of their domestic investment climate (determined by the speed of institutional harmonization), but also on trade liberalization, offering investors in CIS economies easy access to European markets.



3. Intensification of trade and FDI and the resulting diminishing of the income gap can weaken the income motive of labor migration from several CIS countries and make freer movement of people less politically and socially controversial in the EU countries.
4. Free movement of people is important not only for balancing national labor markets (both in “origin” and “destination” countries) and the current account (in “origin” countries). It is also significant for the development of the domestic SME sector in “origin” countries and the learning experience of more mature market economies and democratic societies, thus, strengthening domestic constituencies in favor of democratic and market reforms (in “origin” countries).
5. Institutional harmonization very often involves substantial social, political and (sometimes) economic costs. Without strong incentives/ potential rewards these costs may be considered too high by societies and politicians in neighboring countries. The traditional pay-off offered by the EU to the CIS countries (very gradual improvement of their trade regime with the EU and technical assistance) seems to be insufficient. A stronger set of incentives should probably include at least a faster pace of trade liberalization and liberalization of the movement of people. In the case of countries that are explicitly interested in EU membership, such a perspective should not be ruled out *a priori*, as it is potentially an important and powerful incentive.

It is a quite recognizable fact that the perspective of EU membership (even if it is very distant in time) can become a very powerful incentive, which speeds up political, economic and institutional reforms, aids in solving ethnic and political conflicts, and mobilizes societies and politicians to accept the most unpopular reform measures and undertake the most difficult modernization efforts. This is the observation which can be drawn from the previous EU enlargement experience, particularly that of Northern Mediterranean countries in the 1970s and 1980s, and Central and Eastern European countries, which joined the EU in 2004 and 2007. The same can be said for Western Balkan countries and Turkey, despite their quite distant timetable of accession.

The situation of CIS countries seems to be less favorable in this respect. In most cases, their societies express limited interest in the idea of deep European integration apart from Moldova, Ukraine and Georgia. But, more importantly, there has been a lack of a serious “European offer” from the EU addressed to these countries and societies, which has made the pro-reform integration incentive unrealistic. At the moment, it is hard to say whether the ENP will provide such an incentive, but this cannot be totally ruled out. Very much will depend on the real interest and determination of individual CIS countries to deepen their economic and political relations with the enlarged EU.

## **6. Summary and conclusions**

Until very recently, CIS countries did not belong to the first ring of EU neighbors and their economic importance as potential partners of the EU was very limited (with the exception of supplying energy resources to the EU, primarily from Russia). This situation began to change with the Eastern Enlargement of the EU completed in 2004 and 2007. The European and Caucasus countries of the CIS region moved geographically from the second to the first ring of neighbors. The NMS from Central and Eastern Europe have closer economic, social and cultural relations with the CIS region than most of the EU old members. In addition, CIS countries, after a decade-long period of severe adaptation output decline, entered the phase of rapid growth, which generates more demand for EU-originated imports and investments, and offers more benefits of enhanced economic cooperation for both sides.

The new geopolitical and economic circumstances led the EU to offer the new cooperation framework, called the ENP, to part of the CIS and the Southern Mediterranean region (Middle East and North Africa). Simultaneously, it launched a similar cooperation framework with Russia. However, the main ENP weakness thus far is its lack of internal balance: the EU expected far-reaching cooperation of the neighborhood countries in areas considered as having priority importance for the EU (for example, energy supply and fighting illegal migration), while it offered very few incentives in exchange. Thus, making this cooperation framework more effective requires a serious enhancement of the rewards using, to the extent possible, the positive experience of the previous EU enlargements. The nature of the contemporary economic relations in the globalized world calls for a more complex package-type approach to economic integration rather than limiting cooperation to some narrow fields.

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