

Scenario Analysis for the Perspectives of the EU-Russian Federation Relationship

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Abstract: *In the current geopolitical environment the “cold” relations between the European Union (EU) and the Russian Federation are not only the consequence of the mutual imposed sanctions after the Ukrainian crisis, but also a result of EU’s increased influence in former Soviet space (especially through Baltic States integration and Eastern Partnership extension). Both Eastern Partnership and the Neighborhood Policy initiatives have been considered as an imminent threat to the Russian hegemonic position in the former USSR member states. In our opinion the EU was not prepared to manage the relationship with Russian Federation in a pragmatic approach, hence in the post-Soviet Union era the Ukraine crisis has led to extreme tension between these two powers which reflected negatively on trade and diplomatic relations. Taking into consideration those realities, this paper presents a scenario analysis regarding the perspectives of the EU-Russian Federation relationship in the light of the impact of political and economical sanctions imposed after the Ukrainian crisis. Our research is based on a quantitative analysis of the two countries trade and FDI flows (before and post the Ukrainian crisis), but also on a qualitative approach based on the most relevant theories about international sanctions.*

Key-Words: *economic sanctions, Ukrainian crisis, EU-Russian Federation trade, FDI flows*

1. Introduction

After the disappearance of the USSR, the EU-Russian Federation relationship was an oscillatory one with positive and negative phases in terms of assimilation of a democratic regime and a market economy in the Russian society. In the Russian Federation, the transition from Communism (a totalitarian political and economic system) to an authoritarian oligarchy (the current regime) occurred simultaneously with country’s declining military and political influence (during the former president Yeltsin regime) in the international arena. This decline was followed by a relative economic recovery and by Vladimir Putin regime’s efforts to restore the country’s superpower status in the international relations. It should be noted that Russian efforts to “reborn” as a major global player occurred amid great transformations¹ in the international political system (the EU enlargement being the most important factor). While the Russian Federation has started to consolidate its economic recovery (briefly interrupted by the international and economic crisis impact in the 2009), a new

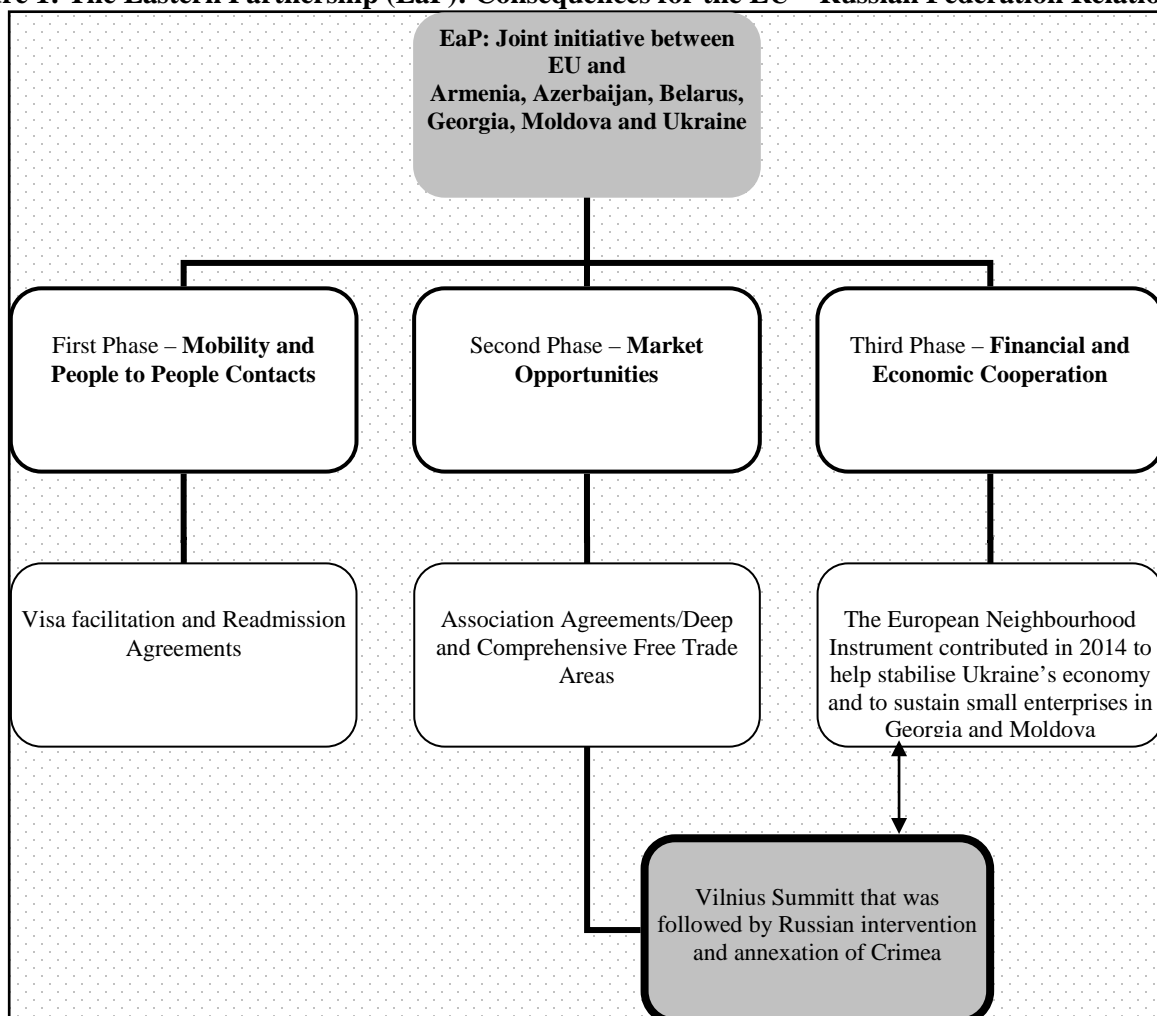
¹ A new wave of democracy was born worldwide as the old Communist regimes collapsed in the Eastern Europe and as the US abandoned its support for authoritarian right-wing regimes in Latin America, especially, as the country no longer felt the need to stop the USSR possible influence in those countries.

focus on democracy and human rights as an outcome of foreign policy has boosted in all the former soviet countries, while the Eastern Partnership was launched as a pillar of the EU's cooperation with former USSR member states. This continuous expansion of the EU's influence toward the East has reached its limits on the Vilnius summit² that was the starting point for the Ukrainian crisis.

2. From the Eastern Partnership to the Ukraine Crisis

As some authors have underlined (Penkova, 2014) the Vilnius Summit was “a critical turning point for the EU to assess its Eastern Partnership’s effectiveness, potential and regional challenges”. The same analysis highlights the fact that the dramatic events in Ukraine should not be analysed as a single case but rather as a symptom of the Eastern Partnership’s shortcomings and as an indication of EU ambitions and approach to the common neighbourhood with Russia”. There are some analysts (Demsey, 2014) that have pointed out the fact that Ukraine crisis means that the EU “can no longer continue doing business as usual”, but must reconsider its options concerning both the Neighbourhood Policy and the Eastern Partnership. In order to further analyse these assumptions we should briefly expose the main milestones of the Eastern Partnership (See Figure 1) and how the EU’s actions in the field have slowly, but surely affected the relationship with the Russian Federation.

Figure 1: The Eastern Partnership (EaP): Consequences for the EU – Russian Federation Relationship



² At the Vilnius Summit, held in 2013, Georgia and Moldova initiated trade and association agreements with the EU, while other Eastern Partnership countries -Armenia, Azerbaijan, and Ukraine- rejected the offers. The crisis in Ukraine erupted after its former President Viktor Yanukovich cancelled plans to sign trade and political pacts with the EU at the Vilnius Summit and instead sought closer ties with Russian Federation, triggering protests that drove him from power. Russian Federation annexed Crimea in March 2014 following a referendum staged after Russian forces established control over the Black Sea peninsula, thus starting the biggest East-West crisis since the Cold War.

Source: Authors representation based on the studied literature.

As we may see in the Figure 1, the increased cooperation with the six member states was followed by the Russian Federation reaction after the Vilnius summit. After the Ukrainian crisis EU reacted both by imposing sanctions and by financially sustaining Ukraine. From the above we may say that although the Eastern Partnership was not created as an act "against" Russian Federation, after the accession to power of Vladimir Putin and the revival of the nationalist spirit, this type of initiative was perceived as some sort of "geopolitical game" in which the EU has made the first aggressive move. This perception led to the gradual emergence of tensions between the two parties and culminated with the Ukrainian crisis. In the following sections of our paper we will assess both the effectiveness of the mutual sanctions imposed after the Ukrainian crisis (in terms of changing Russian Federation behaviour toward Ukraine), but also the damages inflicted on the bilateral economic cooperation between the two states.

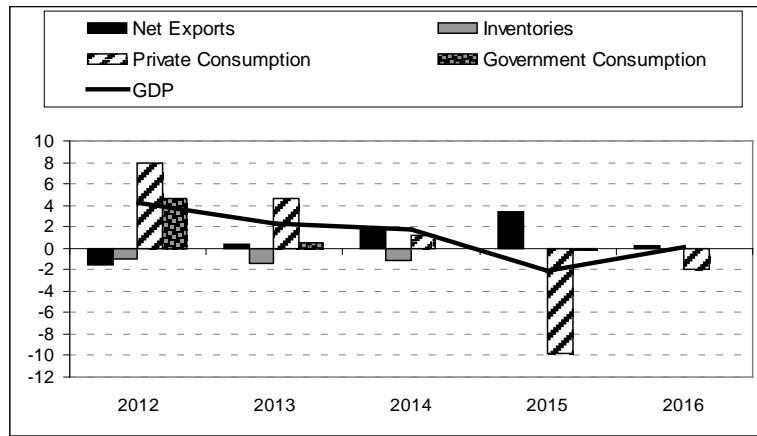
3. The sanctions impact: consequences for the Russian economy and for the economic cooperation with EU

Economic sanctions are an instrument of coercion frequently used in the context of international disputes (Bonnetti, 1998). Given the fact that some studies (Caruso, 2003) are underling that such measures in the economic field are not always successful in changing the foreign policy of the targeted state, our analysis proposes to critically assess the effectiveness of the sanctions imposed on Russian Federation after its involvement in the Ukrainian crisis. Our research has two objectives: on the one hand we assess the impact on the Russian economy (analyzing the effect on trade, FDI flows, exchange rate of the ruble and the capital markets) and on the other hand we highlight if the imposed sanctions had achieved their goal: changing the behaviour of the Russian Federation toward Ukraine. The annexation of Crimea by the Russian Federation led to a "cooling effect" in the economic and diplomatic relations with the European Union (Poladian, Drăgoi, 2014), followed by a series of mutual economic sanctions³ that have reflected badly on the Russian economy. Thus, in 2016, two years after the imposition of sanctions, the Russian Federation is in recession (see Chart 1) while the banking sector is seriously affected by the Russian banks participation ban on the European capital markets⁴.

Chart 1: Russian Federation – Real GDP growth and contributions (%)

³ The EU imposed economic sanctions on Russia's banking, oil and defence sectors. In response the Russian Federation banned the imports of agricultural and food products from the Member States. Russian embargo significantly affected the European agricultural market [European Commission (b)], the most disadvantaged sectors being those of fruits and vegetables, followed by dairy and meat. The Russian ban was prolonged until 2017, in retaliation for the EU decision to maintain the sanctions during 2016-2017.

⁴ The European Union banned five Russian banks (Sberbank , VTB Bank, Gazprombank, Vnesheconombank (VEB) and Russian Agriculture Bank – Rosselkhozbank) from raising capital on the European Union's capital markets as part of a wider package of sanctions imposed to the Russian Federation after the Ukraine conflict. The ban targets Russian banks with state ownership of more than 50% and excludes EU subsidiaries of the Russian banks.



Source: Authors, based on IMF data.

One year after the Ukrainian crisis, the FDI collapsed (see Chart 2) amid capital exodus generated by the distrust in the Russian economy stability correlated with the downgrading of the country rating into the “junk category” (by Moody's and Standar & Poor's). The ruble has also suffered a sharp drop compared to major international currencies (dollar and euro) (see Chart 3).

Chart 2: Inward FDI (USD billions)

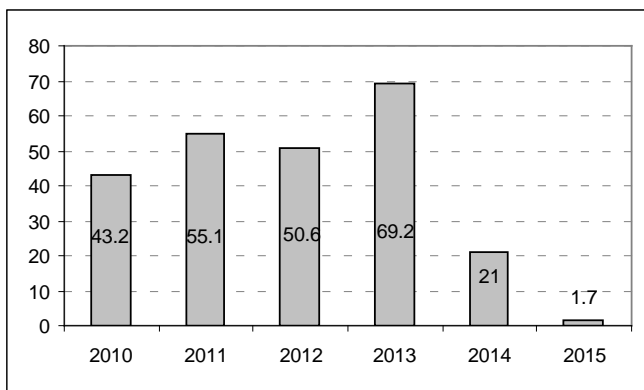
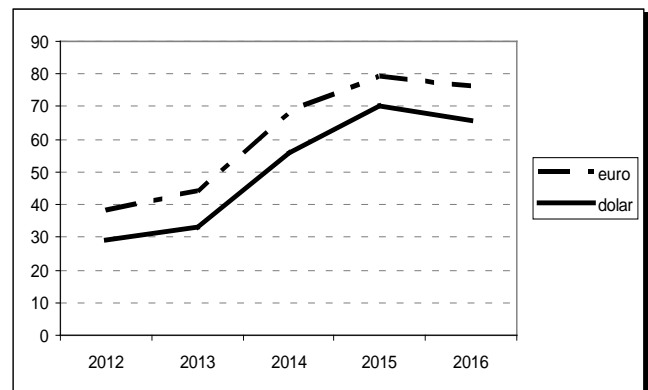


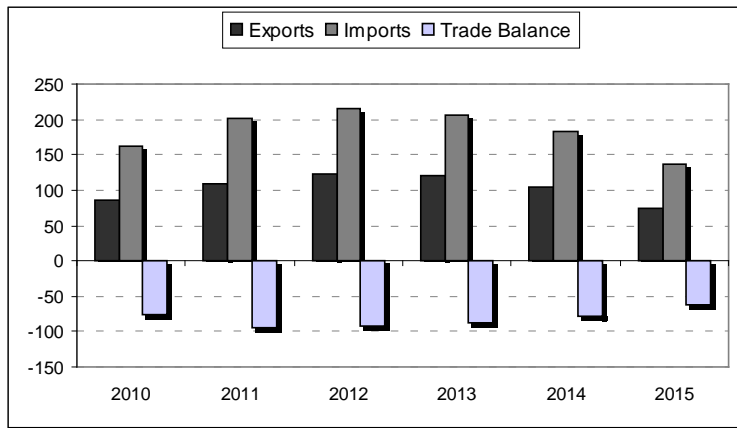
Chart 3: The exchange rate of the ruble



Source: Authors, based on UNCTAD data.

The economic impact of the sanctions was immediate, but failed to change the foreign policy of the Russian Federation. As some recent estimations (European Commission, 2016) are showing “Russian Federation’s economy is set to continue to contracting in 2016, and growth could turn positive from 2017 onwards, although the recovery is expected to be only gradual as structural impediments to growth persist, aggravated further by tightening fiscal policy and only limited space for monetary easing”. The sanctions impact on bilateral trade was also a powerful one (see Chart 4).

Chart 4: Bilateral trade between Russian Federation and EU (billions euro)



Source: Authors, based on Eurostat data.

However, it should be noticed, that, in spite of the sanctions, the EU remain, in 2016, the most important trade partner for the Russian Federation, due to the Russian energy exports in the Member States (See Chart 5 and Chart 6).

Chart 5: EU main sources for oil imports in 2016 (%)

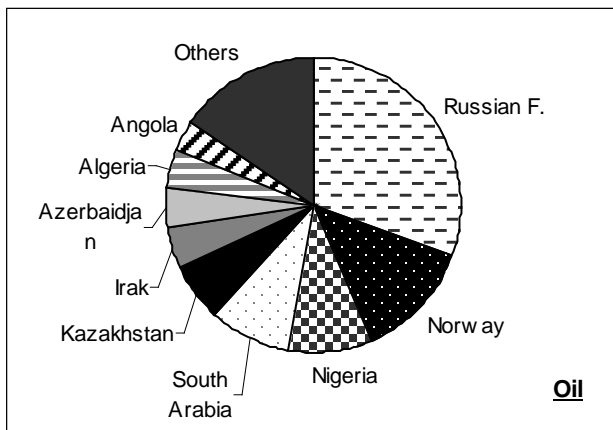
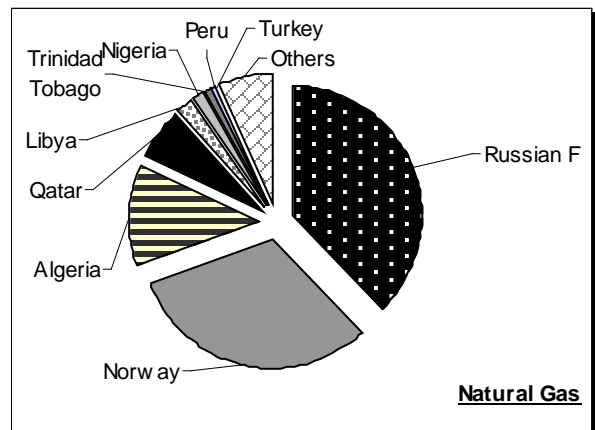


Chart 6: EU main sources for natural gas imports in 2016 (%)



Source: Authors, based on European Commission (a) data.

4. Possible scenarios for the future of bilateral relations

Most studies (Hufbauer et al. 2007; Kaempfer, 2007; Jentleson, 2000; Larn, 1990) show that while the economic efficiency of international sanctions is immediate, such measures are seldom producing a change of the international behaviour that attracted them. Moreover, Jura (2015) highlights that although the economic sanctions are considered a successful pressure tool in the economic field they remain controversial as concerning the foreign policy.

In this regard, it seems important to remember the case of Iran that unquestionably proved that while sanctions could affect the national economy to the point of collapse, the foreign policy of the targeted state may remain inflexible.

Given this reality, some studies (Kholodilin 2014) emphasized that all the sanctions imposed to the Russian Federation (consisting mainly of travel and visa bans and assets freeze for companies and corporations) are unlikely to determine a change of this country behaviour toward Ukraine in the foreseeable future. Galbert (2015) has underlined that after the sanctions enforcement, despite their impact on the Russian economy, they have not altered Russian Federation's strategy to use military force to destabilise Ukraine and retain influence over its future.

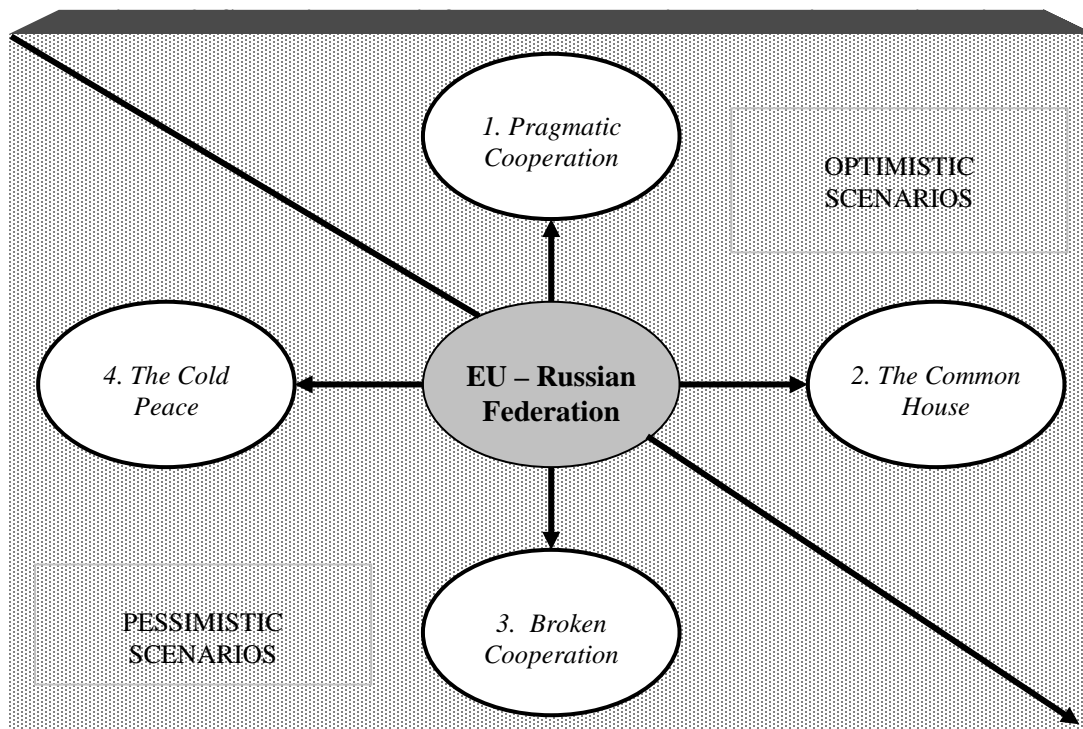
At the contrary, as the same author shows after almost two years of significant economic sanctions, the situation in eastern Ukraine is far from stable, balancing precariously between the possibility of new-scale hostilities and the prospect of long-term frozen conflict – sustained by Russian Federation through its support to separatists and rebel groups. Other studies (Caruso, 2003; Connolly, 2015) have pointed out that contrary to the common vision the sanctions adopted in 2014 have not been designed to isolate Russian Federation from the West in the same way as in the case of Iran, North Korea and Cuba.

Rather than to isolate the country, the sanctions were targeted to have strong impact on the Russian economy. But was it the only affected economy?

Considering the higher degree of integration of the Russian economy into the global markets and even more importantly the strong economic relations between EU and Russian Federation, the sanctions also had a real impact on the member states economies. In the first year after the imposition some projections (Norman, 2014) have shown that their impact for the European economy was important, most affected sectors being those of dual-use goods and technologies, the defence sector and energy – related technologies.

In these circumstances the question naturally arises: is it appropriate to continue such sanctions that are politically ineffective? Taking into account the current tensions and centrifugal forces from insight the EU (Brexit , the crisis of migration, the sovereign debt crisis, the problems of the banking sector, especially the Deutsche Bank case that could become Europe’s next "Lehman Brothers') we believe that the sanctions might be too expensive for the EU, not only for the Russian Federation.

From all the aspects outlined previously in our analysis, we have identified *four possible scenarios* regarding the evolution of the EU - Russian Federation relationship, each presenting a series of consequences as concerning the preservation of a balanced international climate (see Figure 2).



Source: Authors own representation.

1. The scenario that we've named "pragmatic cooperation" would mean that the relations between the EU and the Russian Federation will continue on the basis of common interests, but they will be strictly economic limited, the two parties not sharing common political values. In this scenario between the two countries will be possible a new gradual approach that could reduce the tensions in the bilateral relationship culminating with the renunciation of mutual economic sanctions.

2. The “common house scenario” would involve not only a new boost of the economic relations, but the embracement of common values, perceiving the need for a unit of interest in the face of new global

challenges such as the resurgence of terrorism that pose a global threat. Of course for such scenario to take place, the Russian Federation should renounce to try to put pressure on Ukraine, but EU should also reconsider its position concerning the future of EaP.

3. The scenario entitled "broken cooperation" would mean the returning to a new situation of "Cold War" type where there is no economic cooperation while the divergent ideological values make the political cooperation impossible. Such scenario will be negative for both parties while they are intrinsic linked in terms of economic cooperation: the EU is still Russian Federation's most important trade partner, while the Russian energy exports are vital for the member states.

4. The "cold peace" scenario will involve the preservation of the existing status quo, with no common political interests, but with economic exchanges, while the sanctions are maintained and both parties are enduring the consequences.

5. Conclusions

As we may see there are optimistic and pessimistic possible scenarios for the EU – Russian Federation relationship. However, in the current global geo-political context, shaped by many challenges, resuming economic cooperation without sanctions is, in our opinion, the most desirable outcome. It should be noted however that such scenario should not be accomplished with the price of renunciation from the EU part of political and human rights values in exchange for economic profit. Still, the rebirth of cooperation could occur amid new negotiations in the EaP with the participation of Russian Federation in order to truly build a "shared European house" and a strong economic partnership. Antagonizing Russian Federation is the wrong approach while the Iran case has shown that international isolation may not produce the desired results, but will negatively affect the international climate.

Moreover, some analyzes (Pop, 2016) are highlighting that "in the context of multiple messages that argues the need for a new international order, which obviously will require a new dynamic in the international economic relations and in the global market field, the Russian Federation has the ability to become an influential force in the United Europe".

It should not be neglected the fact that, according to prestigious international analysts (Brezinski, 2016) the future relationship between the EU and the Russian Federation must be thought in the context of the new global realities [the new realities are concerning the priorities of countries aiming to reposition their status in the global arena (USA, EU, China and the Russian Federation), the "Arab spring" and its consequences extended from North Africa to Middle East, the sovereign debt crisis, the migration crisis] which may lead to a new architecture of power within the current international order.

Some authors (Pop, 2016) are showing that these realities may boost a new global realignment of international powers and the creation of a "global equilibrium in the current multipolar world with shared responsibilities".

Undoubtedly, in this context, a pragmatic and cooperative EU - Russian Federation relationship appears, in our opinion, as crucial for achieving this new global equilibrium. In this respect, an approach that is circumscribed to the gradual renunciation of mutual sanctions would undoubtedly be a signal that the Russian Federation and the EU are prepared to restart a dialogue for pragmatic cooperation, finally escaping the trap of the current "cold peace".

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