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# **The Twain Shall Meet: The Prospects for Russia-West Relations**

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The Report of a Joint Working Group  
of  
The Atlantic Council of the United States,  
The Centre for European Reform, and  
The Institute for the U.S. and Canadian Studies at the Russian Academy of Sciences

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## Table of Contents

<i>Foreword</i> .....	v
<i>Executive Summary</i> .....	vii
The Twain Shall Meet: The Prospects for Russia-West Relations	
Overview .....	1
An Ambivalent Relationship .....	4
Russia in the World Economy .....	5
Conclusions and Recommendations .....	10
Building a New Euro-Atlantic Security Framework .....	11
Conclusions and Recommendations .....	15
Russia, the West, and New Global Challenges .....	16
Conclusions and Recommendations .....	20
Bringing Russia into the West .....	21
<b>The Future of Russia-West Relations: Conference Papers</b>	
The Broader Process of Economic Reform and Russia-West Cooperation on Economic Issues.....	25
By Ognian N. Hishov	
Russia in the Globalizing Economy.....	35
By Ivan Ivanov	
Beyond Revival: Building a More Competitive Russia in the Long Term.....	39
By Astrid S. Tuminez	
Building a Euro-Atlantic Security Framework: A European View.....	47
By Benoit d'Aboville	

Building a Euro-Atlantic Security Framework: A U.S. View.....	51
By Jan M. Lodal	
Building a Euro-Atlantic Security Framework: A Russian View .....	57
By Vitaly Zhurkin	
Fighting Terrorism and WMD Proliferation After September 11: What Can We Achieve Together? .....	61
By Gilles Andréani	
The New Trilateral Partnership: Opportunities and Challenges.....	67
By Richard Burt	
The Window of Opportunity in Russian-Western Relations .....	71
By Sergey Rogov	
<i>List of Participants</i> .....	77

## Foreword

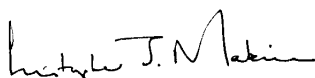
The end of the Cold War left unresolved the nature of the long-term relationship between Russia and the West. This question remained unanswered at the end of the 1990s, a decade during which Russia-West relations fluctuated considerably in relation to domestic and international events, notably in the Balkans. By 2001, with the North Atlantic Alliance and the European Union poised for further enlargement that would not, at least in the immediate future, include Russia, the prospect for longer-term relations between Russia and the Euro-Atlantic countries and institutions remained quite uncertain.

To examine this question, a group of Americans, Europeans, and Russians came together over the past year in an unusual process of triangular discussion. Since the group first met in Moscow in July 2001, there has been increasing cooperation between Russia and the West, especially in the wake of the September terrorist attacks in the United States. NATO is on the verge of agreement with Russia on a new NATO-Russia Council, and the Russian government appears to have set a clearer course towards seeking inclusion in the western economic and security institutions over time. In light of these developments, this report offers some extremely timely analysis, conclusions and recommendations for the U.S., European and Russian governments, as they seek to identify the next steps that will bring Russia closer into the West.

This project involved a collaboration among the Atlantic Council of the United States, the Centre for European Reform in London and the Institute for the U.S. and Canadian Studies of the Russian Academy of Sciences, with the active involvement and assistance of the Carnegie Moscow Center and the Stiftung Wissenschaft und Politik in Berlin. Funding for the project came from the Carnegie Corporation of New York, the German Marshall Fund of the United States and Lockheed Martin Corporation. The organizers are most grateful for this support, without which the project would not have been possible.

The organizers are most grateful to all those who participated in the two conferences that led up to this report and especially to those who contributed papers to lead the discussions, included in the second section of this volume. The report presents the general sense of the discussions and is issued with the support and agreement of the organizing institutions. It was reviewed by the participants in draft, but the participants were not asked to subscribe to every judgment and recommendation in the report. Thanks are due in particular to Frances Burwell, the director of the Atlantic Council's program on transatlantic relations, who drafted the report and succeeded in capturing the essence of complex and many-faceted discussions and rendering it succinctly and clearly.

Finally, I would like to thank my collaborators Charles Grant and Sergey Rogov, as well as Christoph Bertram and Robert Nurick, for their commitment to this project and for the invaluable contributions they made to its success.



*Christopher J. Makins*  
*President, The Atlantic Council of the United States*



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# **The Twain Shall Meet:**

## **The Prospects for Russia-West Relations**

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### **Executive Summary**

The integration of Russia into the West will be one of the most important, and most difficult, tasks facing the United States and Europe during the next decade. Yet a closer relationship with the West will be key to the development of Russian prosperity, democracy, and stability — achievements that will benefit the West as well as Russia. The attacks on September 11 and the resulting campaign against terrorism have given a decisive push to this effort, providing the political will for closer cooperation between Russia and the West.

While the war against terrorism has provided concrete opportunities for collaboration between Russia and the West as they work together against a common enemy, serious obstacles to long-term cooperation still exist. Specifically, there still remain serious differences of perspective and approach on key issues, including nonproliferation, Chechnya, the Middle East, Iran, and Iraq. These differences remain not just between Russia and the West, but also are central to recent tensions across the Atlantic.

The window of opportunity opened by September 11 may not stay open for an extended period of time. Thus, despite the difficulty, there is a need to move forward now with the first steps toward gradual and effective Russian integration with the West. These steps must happen along three critical tracks: integration of Russia into the transatlantic and global economies; the building of a new Euro-Atlantic security system; and responding to new global challenges, including terrorism and proliferation of weapons of mass destruction. Key to the success of this effort will be the ability of all three parties to transcend their differences and stay focused on the desirability of the eventual goal: a stable Russia integrated into a Euro-Atlantic community.

### **Russia in the World Economy**

Although there is now a consensus that the Russian economy is headed in the right direction, there is also a recognition that significant problems remain. The Putin government has concluded that integration in the global economy will be essential if Russia is to achieve the reforms that are key to its future prosperity. But for Russia to participate effectively in the wider economy, it must first face the very difficult task of reforming the Russian economy itself. Without transparent and effective legal regimes in such areas as banking and corporate governance, the Russian economy will not see significant participation by foreign investors. Russian accession to the World Trade Organization (WTO) will be a prerequisite for closer relations with the European Union and will certainly be the key step forward in its

efforts to join the international economy. But joining that organization will also present some very difficult challenges, particularly for those Russian industries not yet competitive in the world market. In the United States and Europe, there is recognition that a stable, prosperous Russia is good for general peace and prosperity. But, with the important exception of energy supplies, the western stake in the Russian economy is limited, and thus the inclusion of Russia in the global economy is rarely given a high priority. Nevertheless, while Russia must take on the major share of the burden of reform, the West can offer targeted assistance and rewards that will ease the way for those in Russia who support constructive change.

### ***Recommendations***

- The Russian government should launch a serious and credible reform program covering the areas of corporate governance and commercial banking. This effort will require firm public support at the highest levels of government, including President Putin.
- The United States and Europe should seek a consensus on a constructive way to alleviate the burden of debt repayment on the Russian economy. One option might be to offer some debt forgiveness in exchange for a defined program of domestic economic reform, or for Russian programs to reduce the dangers of weapons of mass destruction (WMD) proliferation.
- The United States and Europe should offer additional resources to help build a more effective constituency for corporate governance and banking reform.
- To encourage Russian accession to the WTO, the United States and Europe should offer enhanced technical assistance and be flexible with respect to transition periods, while encouraging greater understanding among Russian policymakers and the public of the minimal requirements for accession.

### **Building a New Euro-Atlantic Security Framework**

Since the end of the Cold War, there has been a clear need to restructure the institutional framework that has provided security in Europe for the last fifty years. Although NATO has retained the role of the primary western security organization, there has not been a clear agreement among the allies about the nature of the threats facing the alliance or the consequences for NATO's roles and missions. The aftermath of September 11, and particularly the U.S. decision not to run the military part of the anti-terrorist campaign through NATO, has brought these issues into sharper focus. At the same time, President Putin's firm support of the U.S.-led campaign has brought Russia closer to the alliance than ever before.

It is now time to involve Russia more closely in the evolving arrangements that provide for European security. Specifically, the U.S.–European preoccupation with NATO's future should not be used to delay discussions with Russia about the format of a Euro-Atlantic security framework; instead a trilateral discussion could serve as the catalyst for genuine NATO reform. And while NATO enlargement is an integral part of constructing a new Euro-Atlantic framework, it should be managed in a way that



enhances the relationship between Russia and the candidate countries. The new NATO-Russia Council offers a genuine opportunity to enhance Russian inclusion into western security arrangements, and although many pitfalls exist, it could be an essential mechanism in creating a common approach to the security challenges facing the West and Russia today. Finally, successful Russian involvement in a Euro-Atlantic security framework will require a revamped strategic nuclear relationship with the United States.

### ***Recommendations***

- NATO should adapt its strategic concept to the environment and requirements of the post-September 11 world. This should include a consensus on contingencies that may require the use of military force, which should in turn provide the basis for revising force requirements and operational plans.
- All western militaries — including Russian forces — should be reformed and strengthened so they can deal effectively with the new threats, and the West should seriously consider providing funds and technical expertise to assist the Russians in this task.
- Russian and NATO militaries should collaborate more on a technical level as a means of reducing suspicion and building familiarity.
- The NATO-Russia Joint Council should focus initially on a few key areas of discussion and identify some specific measures that can be undertaken together to address those issues.
- At the next Bush-Putin summit, the United States and Russia should conclude a formal agreement on the framework for their strategic nuclear forces that will involve further reducing the numbers of nuclear weapons.
- A trilateral U.S.-European-Russian discussion on missile defense should be undertaken, as all parties are vulnerable to the missile threat and can be more effective by working together on both technical and political solutions.

### **Russia, the West, and New Global Challenges**

The United States, Europe, and Russia now share a common enemy — international terrorism. But while it has given rise to significant cooperation and a greater shared perspective on the sources of terrorism, the anti-terrorist campaign has also given rise to serious differences. This effort has placed an increased priority on issues over which the United States and its European partners have long disagreed, while Russia often represents a third opinion and brings to the table some key diplomatic and economic links. Although establishing a three-way consensus will not be easy, an effective trilateral effort is particularly needed on three key challenges: the future of the counter-terrorism campaign; proliferation of weapons of mass destruction; and relations with Iran. As the campaign against terrorism moves into the next stage, there is considerable concern in Europe that the coalition will expand its efforts into new areas without adequate consultation or evidence. Meanwhile, Russia has made a significant shift by allowing U.S. troops to be based in former Soviet republics, but this could be upset if the war against

terrorism heads in a direction that President Putin cannot support. The campaign against terrorism has heightened U.S. concerns about proliferation, and especially about the activities of Iraq, which it seems prudent to restrain by any means necessary. In the European view, the focus should be on securing an agreement so that UN inspectors may return to Iraq. Russia brings to this discussion considerable diplomatic resources of value in strengthening the non-proliferation regime. But all too often, Russia and the West have failed to work together on this issue. As for Iran, although U.S. and European officials have often disagreed about the means, they have generally agreed on the goal: a democratic, prosperous state that does not foster Islamic extremism or develop WMD. It is time for Russia to become engaged in western efforts to achieve that goal.

### ***Recommendations***

- The next steps in the U.S.-led campaign against terrorism should be based on careful analysis of intelligence and close consultation among U.S., European, and Russian decision-makers. Because cooperation will be especially important in Central Asia, serious consideration should be given to establishing an anti-terrorism coordination process focused on that region.
- The United States, Europe, and Russia should push for the readmission of the UN inspectors into Iraq, but with the explicit understanding, made clear to the Iraqis, that if that does not work, stronger measures, including the use of force, would be justified and appropriate to enforce the UN Security Council resolutions, and would be supported by the European and Russian governments.
- Russia should strengthen its mechanisms to control exports of sensitive technologies. There is a need for a more coordinated approach to prevent WMD proliferation, and the West should offer to provide the support needed to help Russian promises in this area become reality. Cooperative threat reduction efforts should be reinforced, and the Europeans should undertake a more active role.

### **Bringing Russia into the West**

The aftermath of September 11 offers some powerful opportunities for the United States, Europe, and Russia to work together against a common enemy, and has generated significant political will to bring Russia closer to the West. But serious obstacles to that integration still exist, ranging from conflicts over specific issues to differences over basic priorities. It is not at all clear that the United States and Europe can overcome their current disagreements over the future of NATO and the next steps in the anti-terrorist campaign in order to focus on relations with Russia. Nor is it clear that the Russian government can undertake the reforms required, both domestically and in foreign policy, to make integration with the West both possible and effective. But despite the obstacles that lie before them and the frustrations they will encounter, the United States, Europe, and Russia have much to gain by establishing an effective and genuine trilateral partnership. Building this partnership will be a process, taking many years, if not decades. It will require many changes from both Russia and the West. But that process must start now, using the new window of opportunity. The next several months will be critical in launching this effort, which will benefit all three parties — Russia, the United States, and Europe.

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# The Twain Shall Meet:

## The Prospects for Russia-West Relations

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### Overview

The integration of Russia into the West will be one of the most important — and most difficult — tasks facing the United States and Europe during the next decade. Since the end of the Cold War, the relationship between Russia and the western countries has been ambivalent, sometimes leading to fears of renewed hostility and at other times engendering hopes of true partnership. Yet it has become increasingly clear that a closer relationship with the West will be key to the development of Russian prosperity, democracy, and stability — achievements that will benefit the West as well as Russia. The events of September 11 have reinforced this view and provided a window of opportunity by placing a premium on cooperation in the war against terrorism. But with these new opportunities to collaborate have also come challenges that make the effective integration of Russia into the West a difficult and delicate undertaking with no guarantee of success.

In mid-2001, in response to the obvious importance of the relationship between Russia and the United States and Europe, the Atlantic Council of the United States, the Centre for European Reform, the Institute for U.S. and Canadian Studies of the Russian Academy of Sciences, and the Carnegie Moscow Center initiated a program to consider closer integration between Russia and the West and how it might be achieved over the next three to five years.<sup>1</sup> This project was launched with the understanding that such integration is a desirable end, but that many obstacles stand in the way. Not least among these is the possibility that western policies on such issues as NATO and EU enlargement, missile defense, export controls, and trade, may seem more designed to exclude Russia than to include it in the western institutional system. Nor was it clear that the Russian government was willing or able to support the significant reforms required. The project was also based on the recognition that although the Russia-West dialogue usually occurred on two parallel but distinct tracks — Russia-Europe and Russia-United States — these issues might be more constructively addressed through a trilateral discussion.

The initial meeting of the group, held in Moscow in July 2001, established that this trilateral format could be effective. First, the discussions made clear the diverse nature of existing Russian-western ties, with the U.S. focus on military issues and the Europeans more involved on economic and environmental matters. Simply as a tool to promote better understanding of the comprehensive scope of the relationship, the trilateral format was instructive. The meeting also made clear how difficult it would be to find issues on which cooperation was possible and that also would provide tangible

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<sup>1</sup> Ukraine would also be an important element in efforts to build a truly post-Cold War Euro-Atlantic framework, but in order to keep this project productively focused, it was decided to limit our discussions to the relationship between Russia and the West.

benefits. There was not even a consensus on the nature of the threats faced by Russia and the West, let alone how to respond to those threats. Yet all the participants were aware that without such cooperation and its concrete benefits, suspicions from all sides about the value of Russian integration into the West would remain. The question was not only what integration would require of Russia and of western institutions, but how to generate the political will for a strategy of inclusion that has long-term value but few short-term gains.

The attacks on September 11 and the resulting campaign against terrorism gave a decisive push to Russia-West relations. Perhaps the greatest change has been the support of President Putin for the U.S.-led campaign and his decision to use the opportunity presented by the terrorist attacks to align Russia firmly with the West. The United States and its European allies made clear their desire to respond positively, first as expressed by President Bush at the November 2001 U.S.-Russia summit and then, a month later in December, with the announcement of a proposal for a new NATO-Russia Council.<sup>2</sup> But Russian-western agreement on many specific issues remained elusive, and the path toward genuine Russian integration with the West still seemed far from clear.

In this new environment, the project convened a second meeting in February 2002 in Berlin, hosted by the Stiftung Wissenschaft und Politik. Involving a core group of participants from the earlier meetings as well as new participants, this meeting focused much more directly on identifying specific steps to encourage progressive Russian integration into a Euro-Atlantic framework, even as the relevant institutions seek to cope with the new international environment. Continuing the trilateral format, the meeting focused on relations between the United States, Russia, and the countries of western and Central Europe as they address three challenges:

- The integration of Russia into the transatlantic and global economies;
- The building of a new security system in Europe, which includes nato enlargement, but also establishment of other mechanisms for enhancing Russian participation; and
- The changing international environment, especially the threats of terrorism and proliferation.

Several general conclusions emerged, which demonstrate both how quickly the Russia-West relationship is evolving in the aftermath of September, and how many obstacles and challenges remain.

**1) The political will for closer Russia-West cooperation now exists.** The goal of making Russia part of the West now seems to be widely accepted among the political elites in all three areas. The principal question is how quickly and smoothly integration will be achieved, and at what level of intensity. The details for this transition are still to be worked out and present many potentially serious stumbling blocks. Nevertheless, this is a significant transformation within a period of a few months.

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<sup>2</sup> See Joint Statement on a New U.S.-Russian Relationship, November 13, 2001, viewed at <http://www.whitehouse.gov/news/releases/2001/11/20011114-3.html>. See also Final Communiqué, North Atlantic Council, December 6, 2001, viewed at: <http://www.nato.int/docu/pr/2001/p01-158e.htm>.

**2) The war against terrorism has presented major opportunities for collaboration between Russia and the West.** The campaign against Osama Bin Laden and the al-Qaeda network involved cooperation on intelligence, as well as assistance in securing facilities in and around Afghanistan. The mere fact that western forces are now in Central Asia, and particularly in former Soviet republics, including Uzbekistan and Kyrgyzstan, demonstrates the commitment on all sides to the larger struggle. Of course, this cooperation has not been easy, and in some cases has been guided by rather narrow self-interest. Nevertheless, the impact of working together, even in a rudimentary fashion, against a common enemy should not be underestimated. In addition, the cooperation in and around Afghanistan has brought to the fore the importance of Russia, Europe, and the United States jointly addressing other issues, including the tracking of financial assets of terrorists, the development of weapons of mass destruction (WMD) in Iraq and Iran, and the resumption of the Middle East peace process. It is less clear, however, whether cooperation on these issues can become a reality.

**3) While the opportunities for Russian cooperation with the West have been enhanced in recent months, serious obstacles still exist.** On one level, there remain significant differences of perspective and approach on specific issues, including nonproliferation, Chechnya, the Middle East, Iran, and Iraq. Many of these differences exist not just between Russia and the West, but also across the Atlantic, and persist despite the recognition that these matters can best be resolved through a joint approach. On an even more fundamental level, it is not clear if sufficient incentives exist for either the West or Russia to work toward integration in the short term. From the U.S. perspective, the policy community is focused almost exclusively on the campaign against terrorism, not on the longer-term projects such as rebuilding a Euro-Atlantic security framework. This will change somewhat as the November 2002 nato summit in Prague nears. But even then relations with Russia will be only part of an agenda dominated by questions about nato's future and its role in the context of the anti-terrorism campaign. In Europe, the overwhelming concern about the state of relations with the United States and the future of nato, coupled with a renewed emphasis on the future design of Europe, has limited the attention available for fostering closer relations with Russia. In Russia itself, the obstacles to needed domestic reform (ranging from financial institutions to the military) are still significant and it is unclear whether the government is willing and able to take the steps required to make integration with the West possible and effective.

**4) Despite these obstacles, there is a need to move forward now with the first steps toward gradual integration of Russia into the western order.** By fostering the necessary political will, September 11 has opened a window of opportunity that may not stay open for an extended period of time. To reinforce that political will and thus attain effective Russian integration with the West, there must be some specific measures that lead to clear and visible benefits in the relatively near term. Some of the initial moves will inevitably be unilateral; that is, the United States, Russia, and Europe will each have to take steps independently to ensure that the trilateral relationship is at the forefront of their government agendas and that sufficient domestic support exists to follow through on whatever steps are jointly agreed. But even though these steps are unilateral, their importance for the success of this project should be recognized and steps forward by one party should be rewarded by the others. It should be remembered that this will be a two-way, perhaps even three-way process – all sides will have to change to some degree and all sides will have to benefit for this process to succeed.

With those strictures in mind, the group examined the state of Russia-West relations in the three areas — economic issues, Euro-Atlantic security, and global challenges. It advanced several conclusions and

identified specific recommendations for government action in each area. But it also noted the difficulty of the task and suggested that a key prerequisite is that governments maintain a sharp focus on the desirability of the goal: a stable Russia integrated into a Euro-Atlantic system that will encourage prosperity, security, and democracy.

## **An Ambivalent Relationship**

The end of the Cold War opened a new chapter in relations between Russia and the West, one that reflected deep ambivalence on both sides. The hopes of optimists that a new era of East-West cooperation was dawning were quickly dashed, but the pessimistic prognostications of those who feared an extreme nationalist Russia also proved incorrect. Instead, the 1990s was a time of both cooperation and conflict as the United States, Europe, and Russia began to adjust to the new post-Cold War world. For Russia, the overwhelming priority of this time was to cope with the political, military, and economic dissolution of the Soviet Union and to rebuild new national structures and policies. This decade saw the transition from Gorbachev to Yeltsin to Putin; an attempted coup and a rapidly deteriorating military; the secession of the republics and the outbreak of conflict in Chechnya and elsewhere; and the collapse of the financial system and the rise of corruption and organized crime. Given the magnitude of these challenges, it was entirely appropriate that foreign policy took a back seat, but the consequence was that the reordering of relations with the West was pursued in an uncertain and ambiguous manner. In Europe, the immediate priority was coping with the convulsion of ethnic conflict in the Balkans. Attention was also focused on the building of Europe itself and the integration of Central and Eastern Europe into the European Union. The United States was also focused on Europe, rather than Russia, as it became involved in the Balkans and sought to extend stability eastward through NATO enlargement. The main concern with Russia was the potential for proliferation as its nuclear weapons complex fell on hard times.

With none of the parties primarily focused on the Russia-West relationship — or having defined what that relationship should be — it was no surprise that it veered from harmony to resentment, and sometimes anger. Although Russia participated in the Partnership for Peace and some Balkan operations, its motivations and commitment were often regarded with suspicion in the West. The 1999 round of NATO enlargement, coupled with the NATO air campaign against Serbia, led to a low point in Russia-West relations, with public demonstrations in Moscow against the alliance.<sup>3</sup> The new Bush administration's emphasis on missile defense initially seemed to exacerbate tensions, as did the prospect of a second round of NATO enlargement. But at the same time, a growing number in the Russian leadership seemed to realize that if Russia were to achieve its goals of reform, especially on the economic side, it would need not only a benign international environment, but also the engagement of the West, including the private sector. For the United States and Europe, it was also no longer possible to treat Russia as a side issue. Building "Europe, whole and free," including a stable Balkan region, would require Russian political support (or at least acquiescence), as would controlling the proliferation of WMD around the world. The long term resolution of these issues would require that Russia not

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<sup>3</sup> Indeed, the Kosovo campaign clearly demonstrated how erratic Russian-western relations could be, fluctuating from a low point with the start of the bombing, to a high point with the Russian decision to tell Milosevic that time was up, and then down again with the dash for the Pristina airport.

simply cooperate on an ad hoc, issue-by-issue basis, but move toward more general engagement with the western system.

But what would it mean to integrate Russia into the West? Only thirteen years ago, the West and the then Soviet Union viewed each other as enemies, sought different objectives in the world, and had vastly different political and economic systems. Even after the collapse of the Soviet Union, the division between East and West persisted, represented not only by mutual nuclear deterrence (although the number of nuclear weapons has been reduced significantly), but also by differing assumptions about market capitalism, international stability and security, and the nature of democracy. The successful integration of Russia and the West will require that these differences be narrowed if not overcome. It will also require that Russia have a genuine role in international decision-making, similar to that exercised by Europe and the United States today. Without that level of integration, Russia is unlikely to perceive itself as having a stake in the same international order as the West, with all the benefits and responsibilities that entails. However, integration does not mean that Russia will automatically become a member of all western institutions; in time, it might decide to join some but not others. Nor does integration in this context signify anything as intense as the European Union. But it does mean that Russia should be part of the process of decision-making in the west, that its economy should be compatible and competitive, and that there should be healthy degree of agreement about the ends of policy, even if there are occasional disagreements over the preferred means.

Achieving such integration will not happen overnight. If Russia is to develop a stake in the West—and the West is to develop a stake in Russia’s participation – there must be a gradual process bringing Russia and the West closer together. The first step will undoubtedly be Russian-western cooperation on specific issues. Such cooperation is valuable, both in creating confidence between Russia and the West and in addressing particular challenges before they become truly difficult. But this is only the lower end of the spectrum, and will always be limited as long as Russia and the West hold different assumptions. A medium point on the spectrum, and an important step toward integration, is routine inclusion of Russia in western activities and institutions. This goes beyond cooperation in specific instances to a more generalized effort based on a growing sense of shared understandings and values. It does not, however, necessarily entail the joint decision-making that is characteristic of genuine integration. Also unlike genuine integration, inclusion can be reversed, should either party find this closer engagement undesirable. But inclusion also provides valuable practice in working together. For Russia, it means learning to work constructively in multilateral institutions without an initial automatic “no”; for the West, that means not always seeing Russian hesitations as simply obstructive, but recognizing that Russia has legitimate interests. Moving from cooperation to inclusion to integration will require significant Russian reform, but it will also require the United States and Europe to take steps in return. In particular, Russia and the West must address the three major challenges: bringing Russia into the transatlantic and global economies; building a new Euro-Atlantic security framework; and countering global threats, including terrorism and nonproliferation.

## **Russia in the World Economy**

That Russia’s integration with the West involves a mutually beneficial long-term vision clouded by immediate obstacles can be seen most clearly by examining the barriers and choices facing Russia as it

seeks to reap the economic rewards of a closer connection with Europe and the United States. Since the end of the Cold War, the Russian economy has suffered tremendous upheaval. After the low point of the August 1998 financial crisis, there has been some steady improvement in the economy, and there is a consensus that it is now headed in the right direction. However, there is also recognition that a healthy Russian economy is far from assured, as significant problems remain. Investment has not recovered from the 1998 experience. Not only are foreign companies reluctant to invest, but Russian capital flight continues to be a major issue.

Although the Russian economy has been growing, there is too much reliance on a few enterprises, with little development of the small and medium enterprise sector that is the engine of sustained growth in most advanced economies. Russia remains highly dependent on exports of its extractive industries, especially oil and gas. This makes the economy — including government revenues and expenditures — extremely vulnerable to fluctuations in the price of oil.<sup>4</sup> Along with the lack of investment and over-reliance on a few sectors, the Russian economy suffers from a lack of transparency and accountability, inadequate corporate governance, and a weak judicial system. In fact, the Russian version of “crony capitalism” — “oligarch capitalism” — which gives a few well-connected individuals and firms intrinsic advantages in the economy, is so pervasive that some see it as a form of protectionism that effectively keeps foreign firms from participating in the Russian economy.

In the face of this improved, but still difficult, state of affairs, the Putin government appears to have concluded that integration in the global economy, and especially closer ties with the European economy, will be an essential element in building the reforms that are required if Russia is to prosper in the future. Integration is not so much an end in itself, but a tool for reforming the Russian economy so that it will be more prosperous domestically and competitive internationally. Integration implies that Russia will become a full-fledged player in international trade and finance, willing and able to play by the same rules as others, and to benefit from the open flow of goods and capital between itself and its global partners.<sup>5</sup> For the West, there is a recognition that a stable, prosperous Russia is good for the peace (and prosperity) of Eurasia generally. In this case, economics genuinely is a security issue. For the European Union, which is increasingly concerned about transnational crime and migration from its poorer eastern neighbors, a Russian economy that continues to be dominated by oligarchs with little respect for the law and that offers few opportunities to its own citizens is a potential threat to the stability of Europe itself.

In the short term, however, the Russian economy is not sufficiently large to be important in western economic terms. Russia’s total foreign trade turnover (at \$153 billion in 2000) falls between that of Austria (\$133.7 billion) and Sweden (\$159.3 billion), and its market capitalization of \$123 billion is significantly less than that of many major western corporations.<sup>6</sup> It will be 15-20 years before the Russian economy reaches the size of a medium European economy. Thus, the West has only a modest economic stake in the integration of Russia in the international economy generally. The West, and

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<sup>4</sup> In 2000, crude oil exports accounted for 24 percent of total Russian exports, while crude oil and natural gas combined accounted for nearly 40 percent. Exports of oil and natural gas combined total almost 17 percent of GDP. World Development Indicators database, World Bank, 2001, viewed at [www.worldbank.org](http://www.worldbank.org).

<sup>5</sup> See Astrid Tuminez, “Beyond Revival: Building a More Competitive Russia in the Long Term,” prepared for Russia-West project workshop, February 22-23, 2002. Pages 39 et ff. below.

<sup>6</sup> For trade figures, see [www.worldbank.org/data](http://www.worldbank.org/data). As for market capitalization, Citigroup, for example, has a market capitalization of \$255 billion as of March 2002. Russian figure as of April 23, 2002. See Tuminez.



particularly Europe, does have a considerable stake in Russian oil and gas exports, which comprise over 15 percent of European supplies.<sup>7</sup> With that exception, the support of the West for Russian integration into the international economy is at this point largely based on the political benefits, and is rarely a high priority for governments.

For Russians, the recognition that economic integration and reform are crucial for future prosperity is coupled with an awareness of how difficult those transitions will be. The challenges are particularly apparent in two key areas of domestic economic reform: corporate governance and banking reform.

**Corporate Governance:** The Russian corporate world is viewed by many potential foreign investors as an environment plagued by corruption and disregard for the rights of shareholders and investors. This in turn has discouraged investment, from both foreign and domestic sources. There is certainly justification for this view, but recently there has been some improvement in Russian corporate governance. Some corporations have improved internal accounting standards and methods, published reports to shareholders, and paid dividends. For the most part, however, this improved accountability and transparency is occurring on an ad hoc, voluntary basis. In late 2001, the Russian Federal Commission for the Securities Market (FCSM) took a significant step forward by drafting the first Code of Corporate Governance, which covers management compensation, obligations to shareholders, duties of boards of directors, dividend payments, and disclosure. The priority now must be to persuade more corporations to sign on to the Code, and, over the long term, to develop a non-voluntary mechanism for enforcing corporate governance. The West can offer valuable assistance in this effort.

**Banking Reform:** This is an even more problematic area than corporate governance, with little indication of reform, despite the 1998 financial crisis. For the most part, Russian banks still function primarily as financial arms of large state-run or state-dominated corporations, providing credit and other services. Conflicts of interest are common and the system is vulnerable to manipulation through personal contacts. Unlike western banks, Russian institutions do little retail business (i.e. collecting consumer savings and loaning them to new businesses and others based on a professional evaluation of likely profitability). As a result, it has been very difficult to mobilize capital in Russia into constructive directions, and those seeking capital, especially small and medium enterprises, have found few sources. Until the banking system is reformed, Russia will find it difficult to use capital effectively. Capital flight will continue, new enterprises will be stifled, and Russian businesses supported by improper loans will continue to avoid the hard choices required to be competitive in the world market. As long as this situation persists, inclusion in the international economy will be difficult and will leave Russian banks and corporations vulnerable to pressure from more competitive western institutions. Recently, some steps have been taken to move toward reform of the Central Bank of Russia, but so far few, if any, of the proposals for reform of the commercial banks have been translated into concrete steps. The United States and Europe cannot reform the Russian banking system, but they can work with those in the Russian private sector and government who recognize the importance of those reforms and offer encouragement and expanded technical advice.

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<sup>7</sup> European Commission figures, viewed at [http://europa.eu.int/comm/external\\_relations/russia/intro/trade.htm](http://europa.eu.int/comm/external_relations/russia/intro/trade.htm). In view of the importance of this trade, the EU–Russia summit of October 2000 established a bilateral Energy Dialogue.

The obstacles facing Russian integration into the West are also evident in two major areas where the Russians have already interacted with the international economic system and its rules: debt repayment and accession to the World Trade Organization.

**Debt Repayment:** Ironically, this must be considered one of the current successes of the Russian economy. As the inheritor of Soviet debt (as well as its own), Russia is one of the largest debtors in the world. During the 1990s, Moscow successfully restructured its Soviet-era debt through the Paris Club of creditor nations, and, in 1997, reached a similar agreement, primarily on post-Soviet Russian debt, with the London Club, which consists of commercial banks. After another rescheduling in 2000, there was considerable concern that Russia might default on its debt. Since then, however, higher economic growth has allowed Russia to cover its scheduled payments, and fears of a default have receded considerably. But even this success primarily demonstrates the Russian economy's reliance on energy exports, since its ability to repay the debt has been largely due to higher oil revenues. A significant drop in the price of oil could severely impair Russia's ability to make future payments. Even if the price of oil remains stable, however, debt repayment will still represent a considerable percentage of the Russian budget.<sup>8</sup> Thus, the mere ability to repay debt does not take into account the tremendous opportunity cost involved, particularly in an economy with so many serious needs.

A number of analysts, in the West and especially in Russia, have suggested that forgiving even a portion of the debt could help the Russian economy considerably. It might also send a political signal about the readiness of the West to assist Russia, and if linked to Russian efforts in the area of economic reform or nonproliferation, might help achieve important western goals. One relatively new approach proposed in the United States is to couple the issue of debt repayment to efforts to reduce the threat presented by the risks of the spread of weapons of mass destruction.<sup>9</sup> The idea of treating Russian programs to reduce this threat as an offset to existing debt deserves serious consideration. Similarly, European governments might agree to reduce Russian debt in return for commitments to undertake specific economic or environmental reforms, thus allowing the Putin government to dedicate funds to moving Russia in a constructive direction. Until recently, however, the German government, which is the major creditor (holding 48 percent of Soviet-era debt), had shown little inclination to consider debt forgiveness, and, with other Europeans, had argued that other measures, including economic reforms, will be far more important to a revitalized Russian economy.<sup>10</sup> On April 10, Russia and Germany agreed that Russia will repay \$426 million to Germany to cover \$6.4 billion worth of loans from the Soviet Union to the former East Germany. Whether this is the beginning of a move toward a western consensus on this issue is still unclear.

**WTO Accession:** This is perhaps the key element in Russian integration into the international economy, and it will be one of the most difficult to achieve. It is not unusual for countries with large, complex

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<sup>8</sup> Russian government revenues are estimated to have reached \$49.7 billion in 2001 (Financial Times, April 15, 2002), while debt payments for the same year are estimated at \$13.65 billion (based on European Commission figures of €15 billion), or 27.5 percent of revenues.

<sup>9</sup> The proposed Biden-Lugar legislation, which is part of the Security Assistance Act of 2001, has been passed by the U.S. Senate and is now under consideration in the relevant committee at the House of Representatives.

<sup>10</sup> For a discussion of the Russian economy and debt repayment from a German perspective, see Ognian Hishow, "The Broader Process of Economic Reform and Russian-Western Cooperation on Economic Issues," prepared for Russia-West project workshop, February 22-23, 2002. Pages 25 et ff. below.

economies to take considerable time to negotiate accession (China took 16 years; Russia began negotiations in 1993). At the moment, the United States, Russia, and Europe all seem agreed that Russian membership in the WTO is a desirable goal; the question is when this will happen and under what conditions. Both Russia and the West will gain considerably from Russian WTO membership. Russia is currently estimated to lose \$3 billion per year in trade-related income because it is not a member.<sup>11</sup> Membership will also reinforce necessary and valuable domestic economic reforms. Giving Russia a seat at the table where international trading rules are established is an important symbol of legitimacy and acceptance, and participation in the system will enable Russians to tackle barriers to their exports and to gain experience in a rules-based system. For the West, Russian membership in the WTO will reduce tariff and non-tariff barriers, while also enhancing transparency and accountability in transactions.

While the Putin government favors Russian accession, considerable skepticism is emerging among corporate and other outside analysts. This is derived primarily from concerns about Russia's lack of competitiveness. Once the Russian economy is open to the forces of globalization, it is feared, national corporations and banks would not be able to compete against stronger western enterprises. There is some basis for this view. Without creating the incentives that will make domestic companies competitive, Russia will find itself a victim of globalization, not a beneficiary. Russian skepticism is also derived from concerns about the intrusiveness of WTO rules, including concerns that some subsidies and regulations will be found to violate the WTO's core principles of national treatment and non-discrimination.

Despite these Russian concerns, WTO membership is the key to unlocking closer economic and political ties with the EU. The EU's 1997 Partnership and Cooperation Agreement with Russia held out the prospect of an eventual free trade area. But the EU has made clear that WTO accession is a prerequisite, since joining that club would make Russia change in ways that would make a free trade area easier to negotiate, notably in accepting the importance of external rules. In mid-2001, European Commission President Romano Prodi floated the idea of Russia joining a "European Economic Space" (EES) which would bring it into the single market.<sup>12</sup> Such an arrangement would go beyond a simple free trade area by removing non-tariff barriers to trade. The Russian economy will not be ready to compete in a true single market for many years, perhaps even decades. But if the EU and Russia were to agree to a target date, perhaps 2015, for including Russia in the European economy through the EES or something similar, it might provide an incentive for identifying the next steps Russia should take and the type of assistance the EU should provide. Since 1991, the EU's TACIS program has provided more than 600 million euros in assistance to Russia for administrative reform and economic development, with mixed results. The 2002-2003 TACIS program places a clear emphasis on preparing Russia for WTO membership and developing the EES, but its success is far from assured.<sup>13</sup>

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<sup>11</sup> See Tuminez.

<sup>12</sup> For a discussion of Russian views on a Common European Economic Space, and globalization generally, see Ivan Ivanov, "Russia in the Globalizing Economy," pp. 36-37 below.

<sup>13</sup> European Commission, Country Strategy Paper for the Russian Federation, 2002-2006, December 2001, viewed at [http://www.europa.eu.int/comm/external\\_relations/russia/csp/02-06\\_en.pdf](http://www.europa.eu.int/comm/external_relations/russia/csp/02-06_en.pdf).

The internal Russian debate over the desirability of WTO accession highlights the dilemma facing Russia: while many of the demands of the West may seem intrusive and arbitrary to some Russians, these same internal reforms are essential for a successful integration into the international economy. WTO accession without reforms may have exactly the impact on non-competitive sectors that is feared by Russian skeptics. This is not a dilemma that Russia can resolve on its own. The United States and Europe must be clear as to the minimum level of reforms that would make accession both possible and responsible, and they must be flexible on the issue of transition periods in some sectors. While cooperating closely with the private sector and relevant NGOs, Europe and the United States should expand their technical assistance programs and target them toward WTO accession. No one will benefit if Russia's eventual accession to the WTO leads to anything other than greater prosperity.

### *Conclusions*

- As Russia seeks to integrate into the global economy, the primary requirement is the reform of the Russian economy itself. Without transparent and effective legal regimes in such areas as banking and corporate governance, the Russian economy will not see significant participation by foreign investors.
- The western economic stake in Russian integration to the West is limited, with the important exception of energy supplies, and thus U.S. and European support for including Russia in the western economy is primarily based on political considerations.
- Russian accession to the WTO will be a prerequisite for closer relations with the European Union, and will certainly be the key step forward in its efforts to join the international economy, but it also presents some very difficult challenges.
- While Russia must take on the major share of the burden of reform, the West can offer targeted assistance and rewards that will ease the way for those in Russia who support constructive change.

### *Recommendations*

- The Russian government should launch a serious and credible reform program covering the areas of corporate governance and commercial banking (other areas could undoubtedly be added, but these are key sectors for early reform). This effort will require firm public support at the highest levels of government, including President Putin.
- The United States and Europe should seek a consensus on a constructive way to alleviate the burden of debt repayment on the Russian economy. One direct approach would be to offer to forgive a moderate portion of the Russian debt in exchange for a defined program of domestic economic reform initiated and designed by the Russians. But the idea of offsetting debt with Russian programs to reduce the dangers of the proliferation of weapons of mass destruction from their nuclear and other programs should also be examined by all the countries concerned.

- The United States and Europe should offer additional resources to help build a more effective constituency for corporate governance and banking reform. This could include educational efforts directed at regional politicians, business leaders, and citizen groups. When appropriate, they should work with private sector institutions to encourage their Russian colleagues to provide unambiguous support for such reforms.
- To encourage Russian accession to the WTO, the United States and Europe should offer enhanced technical assistance in support of specific Russian efforts to meet WTO requirements and be flexible with respect to transition periods in some sectors. The West also needs to work closely with Russia to create more understanding of the minimal requirements for accession, both among policymakers and the public.

## **Building a New Euro-Atlantic Security Framework**

Since the end of the Cold War, there has been a clear need to restructure the institutional framework that has provided security in Europe for the last 50 years. With the Warsaw Pact dissolved, it first appeared that NATO might become a historical leftover, and that either the European Union or the Organization for Security and Cooperation in Europe would evolve into the main security institution for the continent. Neither proved up to the task, and the allies in any case preferred to reform NATO to make it more relevant to the new security circumstances. Through the Partnership for Peace and later through enlarging the alliance itself, NATO helped stabilize the countries of Central and Eastern Europe and anchor them firmly into the West. Through intervention in the Balkans, it helped address the most serious post-Cold War threat to European security.

But this evolution happened on a largely ad hoc basis. There was never a firm agreement among the allies about where NATO's evolution should end: what would be the threats facing Europe in the first decade of the new century? Should the alliance take on new missions, and if so, should the alliance take on responsibilities outside Europe? Nor was there agreement on where Europe ends: was Russia a potential NATO member? What should be the relationship of Russia to a restructured pan-European security framework? Throughout the 1990s, it was not at all clear that Russia wanted to be closely tied to NATO. It participated in the Partnership for Peace in a limited way, and the Permanent Joint Council was established to provide a forum for Russian discussions with the 19 NATO members. However, the NATO bombing of Serbia during the Kosovo campaign led to a breakdown in the PJC, which the Russians had in any event discounted as a mere informational forum, rather than a coordinating body.

The aftermath of September 11 brought these issues into sharper focus and added a sense of urgency that they be seriously addressed. Although NATO had moved quickly to invoke Article 5, the United States did not involve the alliance as such in the military campaign against terrorism. Many European allies provided intelligence, special forces, or other limited military assets, but outside the framework of a NATO operation. What did it mean that the most powerful alliance member had opted to operate outside NATO? Was NATO irrelevant in responding to the new missions of the twenty-first century? At the same time, the anti-terrorism campaign made clear that Russia could no longer be treated as a secondary player. President Putin's firm support of the United States, coupled with Russia's experience

in Afghanistan and with Islamic extremism in general, has made it a key partner in the conflict with al-Qaeda (albeit not a military one). Is Russia now a de facto member of the western security framework?

The time has come to involve Russia more closely in the evolving arrangements that provide for European security. The Russian government has stated its desire to be part of that framework, and as the institutions concerned with European security enlarge, engaging Russia more consistently and constructively will be essential to strengthen regional stability and harmony. With September 11 having brought the issue of NATO's mission and future to the fore, there is now a valuable opportunity to reform the transatlantic security framework and at the same time, to strengthen Russia's link to that structure.

This effort will face two impressive challenges, however. First, other than a general desire to belong, Russia does not seem to know what it wants for this new, closer relationship. At a basic, minimal level, Russia wants to see the last vestiges of NATO as a Cold War, anti-Soviet institution disappear. But this has been happening gradually as European governments undertake military reform and as the roles and missions of NATO shift. A bigger challenge is to define the nature of Russian inclusion in the European security framework.<sup>14</sup> Will this entail eventual actual membership in a reformed NATO? Or would a distinctive institutional link (perhaps an associate membership or an "alliance with the alliance") be more appropriate for a country that is not simply one among many European states? It may be that a special arrangement of some sort is the best way to recognize Russia's geographical reach and its status as a nuclear weapons power. But beyond the question of the institutional form Russian integration in the West will take, it is unclear how Russia wants to use its desire to have an equal status in the decision-making, not only on issues affecting its own security, but on Article 5 and other NATO missions. Can Russia substantially contribute to western security? And does the West really want to involve Russia in the consensus-based joint decision-making within NATO? There is a strong concern that Russia will try to veto those NATO actions with which it disagrees. The delicate task of the integration of Russia will need to be managed without undermining the cohesion of the West.

Second, the United States and its European allies are increasingly absorbed in an internal debate about the future of NATO and their ability to cooperate militarily. It will be difficult to shift the focus of attention to the question of how to integrate Russia into a security structure that is already facing significant questions about its roles and even its future. This debate is complicated by the development of the European Security and Defense Policy (ESDP) and uncertainty about its link with NATO.<sup>15</sup> The growing support within the EU for a military deployment in Macedonia may indicate greater EU willingness to shoulder the burden of providing security in Europe, but it is not yet clear that mechanisms of NATO-EU cooperation can be established in time to make the deployment worthwhile. To insert the issue of greater Russian participation into this shifting and uncertain European security framework risks overloading the transatlantic discussion and pushing a delicate balancing act into chaos. Yet any arrangements arrived at without taking Russian concerns and aspirations into account could hardly be considered final.

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<sup>14</sup> For comments on the possibilities for and limitations on a Russia-NATO cooperative framework, please see Benoit d'Aboville, "Building a Euro-Atlantic Security Framework: A European View," p. 47 below.

<sup>15</sup> For a Russian view of the problems posed to Euro-Atlantic security by any potential ESDP-NATO rift, see Vitaly Zhurkin, "Building a Euro-Atlantic Security Framework: A Russian View, p. 57 below.

If Russia is to be effectively integrated into a new Atlantic security architecture, it will require a trilateral United States-Russia-Europe examination of several key issues. These will all be complicated by uncertainty over the specific nature of Russian involvement and contributions and by the natural tendency of long-term allies to address transatlantic differences first. Yet a trilateral consensus on the issues of NATO's future roles, enlargement of the alliance, a NATO-Russia institutional link, and the overall strategic relationship, is essential.

**NATO's Future Roles:** The most fundamental issue is that of NATO's roles and missions in the post-September 11 world. The invocation of article 5 did not make NATO as an institution a central player in the anti-terrorist coalition, throwing in doubt the relevance of the alliance to the challenges now facing the West. Twelve years after the Cold War and eight months after September 11 the conclusion is clear — NATO must reform to survive.<sup>16</sup> Given especially attitudes in the United States, it cannot cease to be a collective defense institution (although that role may diminish), but must also address the causes of insecurity facing Europe today, including terrorism and proliferation of WMD. This will require a new tolerance for out-of-area missions, whether undertaken by NATO per se or by alliance members in ad hoc coalitions through the Combined Joint Task Force (CJTF) procedures. September 11 seems to have erased much allied reluctance to confront this necessity, but difficult questions will remain over the authority for such action. Such a change will also require that NATO's strategic concept be reviewed and adapted to the requirements of the new international environment, so that it addresses the comprehensive security needs of the West and its Russian partner. Finally, such a change will require a new approach to ensuring the development of adequate alliance capabilities. It is unlikely that the European allies will increase their defense spending to any great extent. But they can be more effective in how they structure their forces and spend their limited funds. They will not catch up with the United States, but they could fill key niches solidifying the stability of Europe (especially the Balkans) and addressing the new threats. Changes will also have to be made in NATO's command structure and in U.S. forces, both of which are still largely oriented toward Cold War missions.

In all of this, the participation of Russia will be essential. If Russia is not to view out-of-area missions or NATO's new strategic concept with suspicion, it must be involved and informed (although not necessarily with a decision making role). Russia could be encouraged to take a more active role in the Partnership for Peace, especially as the emphasis on Central Asia increases. Russian officers could also be brought into the more technical process of force reviews, exercises, and even joint force planning. One of the most valuable steps the West could take is to integrate Russia into its own efforts at military reform and perhaps provide at least some of the significant assistance that will be required if the Russian forces are to be transformed into effective coalition partners without placing an unsustainable burden on the Russian society and economy.

**NATO Enlargement:** At the November 2002 Prague Summit, NATO will extend invitations to several new members, taking another big step towards completing "Europe whole and free." By bringing into the fold countries that represent the dissolution of the East-West divide, the alliance increases the need for its own transformation and for the involvement of Russia. President Putin has indicated that he does not view NATO enlargement as a hostile act. Many western observers believe that if present

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<sup>16</sup> For a detailed discussion of the challenges NATO must overcome if it is to remain at the center of the Euro-Atlantic security framework, see Jan Lodal, "Building a Euro-Atlantic Security Framework: A U.S. View," pp. 51-55 below.

Russian relations with the three newest alliance members are any indication, relations between Russia and the candidates admitted in Prague are likely to show steady improvement. But many in Russia do not understand or agree with the need for NATO's enlargement. Thus it is necessary to conduct enlargement without adding suspicion and tension between Russia and the new members. Enlargement should not be viewed as separate from NATO's relations with Russia. Implementing enlargement without regard for Russian sensibilities and without engaging Russia in discussions about the roles and missions of an enlarged NATO will only enhance suspicions among those already so inclined in Moscow. Instead, enlargement may offer, for example, an opportune time to revive Russian dialogues with NATO members on its borders, including Poland and the Baltic states, if the latter enter the alliance in 2002. Steps should also be taken to address Russian concerns about Kaliningrad, which will inevitably become a more sensitive issue with both NATO and EU enlargement. It may not be possible to take all Russian concerns into account, but enlargement coupled with a more active and intense NATO-Russia link could provide a strong foundation for a new Euro-Atlantic security framework.

**NATO-Russian Institutions:** In December 2001, the North Atlantic Council announced an agreement to construct a new NATO-Russia Council, which would operate on the basis of consensus not at 19+1, but at 20. In theory, the new Council will give Russia equal status on select issues. Much remains uncertain about the procedures and scope of the Council, nor is it clear how effective it will be in fostering partnership between Russia and the West. It could be a key forum for enhancing Russian understanding of NATO and its concerns and western awareness of Russian sensibilities. Or it could falter, as did the Permanent Joint Council, over ambiguities in its role and tensions in the larger relationship. If the latter fate is to be avoided, all parties must approach the new Council with a commitment to its success, as demonstrated by the caliber of the diplomats assigned to the Council and the instructions they are given. In the Council discussions, the stress must be placed not on questions of status and institutional minutiae, but on finding appropriate areas for the United States, Russia, and Europe to address together. These may include counter-terrorism, proliferation of WMD, safeguards against nuclear, biological, and chemical attacks, and the Balkans, as well as crisis management and peacekeeping operations more generally, and perhaps even search and rescue or border enforcement. At first, the best strategy for the NATO-Russia Council may be to focus on a few key issues where agreement on specific actions is necessary and attainable, rather than comparing perspectives over a broad swath of topics, which could serve to heighten differences. If the Council can identify specific, cooperative steps NATO and Russia can undertake in response to key challenges, it may become a key mechanism integrating Russia into the West.

**The Strategic Framework:** Although not strictly an alliance issue, the balance of strategic nuclear weapons between the United States and Russia has always underpinned the European security framework. But rather than simply maintaining these weapons out of habit from Cold War, a way needs to be found to make them guarantors of security across the Euro-Atlantic world. The goal should be to move the Russia-U.S. strategic relationship beyond mutual assured destruction and make it similar to the U.S.-U.K.-France relationship. For this to happen, the United States and Russia must quickly take some serious steps toward greater reduction of nuclear weapons (including dismantlement of warheads) and enhanced transparency between the two nuclear establishments. This arrangement must be formalized in a legally binding way and be more than an understanding between particular administrations. It is



widely expected that such an agreement will be achieved at the May 2002 Bush-Putin summit.<sup>17</sup> If that happens, it would provide Putin with a valuable demonstration that the West will address Russian concerns seriously. But that agreement must be followed up by careful implementation and continuing dialogue about strategic priorities and concerns.

Although this discussion will inevitably be primarily bilateral, the resulting shift in the strategic framework will go far to enhance security for the entire Euro-Atlantic area. The effect of this bilateral discussion should be reinforced by a genuinely trilateral consultation about missile defense. Although this issue has been divisive in the past, Russia and the West certainly share a vulnerability to ballistic missile attacks. A dialogue about this shared threat and a joint strategy to respond could do much to build a genuine Euro-Atlantic security framework.

Although the emphasis here has been on NATO and the U.S.-Russian relationship, it should not be forgotten that the European Union — and thus the EU-Russia relationship — is a key element in any Euro-Atlantic security framework. In 1999, the European Union adopted a common strategy toward Russia, outlining its commitment to work with Russia on a range of issues from security to the environment to economic reform. Yet, apart from the provision of TACIS assistance and an intensified dialogue, there “is still a notable discrepancy between the ambitions expressed in the dialogue and the actual results achieved.”<sup>18</sup> In 2004 or 2005, the European Union is likely to bring in several new members, expanding its border with Russia considerably and encircling the Russian enclave of Kaliningrad. This situation will make it even more imperative that Russia and the EU build on the common strategy to develop an effective means of addressing bilateral security issues, while keeping the United States well informed. In particular, cooperation over trafficking in drugs, humans, and weapons should be enhanced. Because Europe will not be able to assume that the Schengen regime will create a *cordon sanitaire*, insulating the EU from international ills, discussions over policing and other border issues will be a key component of EU-Russian relations in the future. Finally, the EU should keep Russia well-informed about the development of the European Security and Defense Policy, and especially the evolution of a Rapid Reaction Force and the provisions for non-EU members to participate in possible future operations. Building a stronger EU-Russian relationship, especially as the EU expands both in territory and into security and defense policy, will be a key foundation stone in any future Euro-Atlantic framework.

### ***Conclusions***

- The U.S.-European preoccupation with NATO’s future should not be used to delay discussions with Russia about the format of a Euro-Atlantic security framework; instead a trilateral discussion could serve as the catalyst for genuine NATO reform.
- NATO enlargement is an integral part of constructing a new Euro-Atlantic framework and should be managed in a way that enhances the relationship between Russia and the candidate countries.

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<sup>17</sup> An arms control agreement was signed at the United States-Russia summit, but it is still unclear whether that agreement was specific enough to have significant impact.

<sup>18</sup> EU Council of Ministers Report to the European Council on the Implementation of the Common Strategy of the European Union on Russia, prepared for the Göteborg European Council, June 15/16, 2001, viewed at [www.europa.eu.int](http://www.europa.eu.int).

- The NATO-Russia Council offers a genuine opportunity to enhance Russian inclusion into the West, and although many potential pitfalls exist, it could be an essential mechanism in creating a common approach to many of the security challenges facing the West and Russia today.
- Successful Russian involvement in a Euro-Atlantic security framework will require a revamped strategic nuclear relationship with the United States.

### ***Recommendations***

- NATO should adapt its strategic concept to the environment and requirements of the post-September 11 world. This should include a consensus on contingencies that may require the use of military force, which should in turn provide the basis for revising force requirements and operational plans.
- All western militaries — including Russian forces — should be reformed and strengthened so they can deal effectively with the new threats, and the West should seriously consider providing funds and technical expertise to assist the Russians in this task.
- Russian and NATO militaries should collaborate more on a technical level as a means of reducing suspicion and building familiarity.
- The NATO-Russia Joint Council should focus initially on a few key areas of discussion and identify some specific measures that can be undertaken together to address those issues.
- At the next Bush-Putin summit, the United States and Russia should conclude a formal agreement on the framework for their strategic nuclear forces that will involve reducing the numbers of nuclear weapons.
- A trilateral U.S.-European-Russian discussion on missile defense should be undertaken, as all parties are vulnerable to the missile threat and can be more effective by working together on both technical and political solutions.

## **Russia, the West, and New Global Challenges**

For the first time in many decades, the United States, Europe, and Russia share a common enemy — international terrorism. The attacks on September 11 not only claimed victims from around the world, but revealed the sophistication and extent of the terrorist networks. Individually, all three had experienced terrorism before, but now — with the declarations of support from across Europe and from President Putin — the United States, Europe, and Russia seemed determined to fashion a collective response. In the months after the attacks, there was significant cooperation in law enforcement, financial reporting, judicial work, and intelligence. This can be expected to continue and grow, as more permanent cooperative arrangements are negotiated. Indeed, this type of cooperation

may well turn out to be the most effective means of uncovering and stopping the sophisticated terrorist networks of the 21st century.

Apart from specific measures, the aftermath of the attacks also led to greater understanding between Russia and the West. The Russian government had long identified radical Islam as an important source of terrorism, responsible for some of the unrest in Chechnya and elsewhere in its south, as well as bombings in Moscow. In the view of at least some Russians, the West finally recognized the value of the Russian perspective and experience. While U.S. and European governments remained justifiably cautious about the causes of the Chechnya conflict, their enhanced recognition of the threats faced by Russia has done much to reinforce a harmony of views after September 11.

This is not to say that cooperation in the anti-terrorism campaign has been without difficulties. In particular, there has been much less cooperation on the military elements of the response. Russia offered only a modest military contribution to security in the Kabul area, but given its recent history in Afghanistan, this was viewed as appropriate. Many European allies also offered military assets, but with a few exceptions, primarily for special forces, the United States did not initially take up those offers, opting instead for the efficiency of non-coalition warfare. Although coalition partners have become more involved militarily in the peacekeeping force based in Kabul and, individually, in some combat operations, the former does not include U.S. forces, and so has done little to assuage the sense of U.S. distinctiveness. The result, at least in the perspective of some Europeans, has been some erosion of the sense of common purpose.

More importantly, as the campaign against terrorism moves into the next stage, some serious differences have arisen in the transatlantic relationship, despite the recognition of a common threat. Indeed, this effort has placed an increased priority on issues on which the United States and its European partners have long disagreed, such as the Israeli-Palestinian conflict and the value of engagement with Iran. This is not simply a transatlantic squabble. Russia often represents a third opinion on these issues, and brings to the table diplomatic and economic links with some difficult actors in the region. Unfortunately, differences between the United States and Europe often distract from the trilateral discussion that needs to be undertaken. Unless there is adequate coordination with Russia on these issues, there is always the risk that western efforts may be undermined, or that Russia and the West may divide their efforts by supporting the conflicting parties. The engagement of Russia and its inclusion in western efforts to resolve these challenges could be in the interest of all.

An effective trilateral effort is particularly needed on three key challenges the coalition will face: the future of the counter-terrorism campaign; proliferation of weapons of mass destruction, including in Iraq; and relations with Iran.<sup>19</sup> Establishing a three-way consensus on these issues will not be easy. Behind their differences on specific issues, the United States, Europe, and Russia are divided on a more fundamental level over the appropriate foreign policy priorities. For many in Europe, the focus should be on building a world of multilateral legal regimes to address a range of challenges. For the United States — often accused of unilateralism by its European partners — the emphasis since September has been on destroying al-Qaeda and fighting terrorism generally. For Russia, the priority is on preventing

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<sup>19</sup> For a wider view of areas in which trilateral cooperation could be beneficial, see Richard Burt, “The New Trilateral Partnership: Opportunities and Challenges,” p. 68 below.

instability in its neighborhood leaking across its borders and on strengthening its international economic position. Thus, in addressing global challenges, it is not just a matter of bringing Russia closer to the West, but of harmonizing western viewpoints on these matters. This can best be done by focusing on the specific next steps required for the West and Russia to move toward achieving their agreed aims.

**Future of the Anti-Terrorism Campaign:** As the military campaign in Afghanistan appears to be reaching a conclusion, the coalition is beginning to grapple with two questions: How should the anti-terrorism campaign be pursued beyond Afghanistan? Who will rebuild Afghanistan, and by implication, other societies that are disrupted in the hunt for terrorists? President Bush, by identifying an “axis of evil” in his January State of the Union speech, has alarmed many coalition partners, who fear that the U.S. effort — and thus by implication the coalition — will expand its efforts into new areas without adequate evidence or consultation. The European allies have focused on the possibility that the campaign may reach to Iran, Iraq, or even across the globe to North Korea, and worried that they will have little say in any new efforts until they are asked to pay for the reconstruction.

The Russians, on the other hand, have been concerned about regions closer to home. The recent deployment of U.S. troops to train Georgians in connection with the situation in Georgia’s Pankisi Gorge, coupled with the construction of military bases in other former Soviet republics, could be viewed with alarm in Moscow. So far, however, President Putin’s commitment to the anti-terrorist effort has kept Russian suspicions about permanent deployment of U.S. forces from producing a serious crisis, which threaten the cohesion of the U.S.-led coalition. This represents a significant shift toward the West, but also remains a sensitive situation that could quickly degenerate into recriminations, particularly if new targets in the campaign lead to a change in U.S. activity in the former Soviet republics. Under these circumstances, there must be an active dialogue between Russia and the West on the scope and direction of anti-terrorism measures, especially as they affect Central Asia. The West should acknowledge Russia’s legitimate security concerns in the region. It may be appropriate, for example, for the Chechen terrorist organizations to be added to the U.S. list of such groups, and the West could offer to assist in the rebuilding of Chechnya. But it should also be clear that the anti-terrorism campaign does not provide anyone with a blank check. Russia should not use anti-terrorism as a foundation for establishing an exclusive Russian influence in neighboring states, just as the United States should not undertake sudden, large deployments against a new target, without adequate consultation or providing relevant evidence. The greater western involvement in the former Soviet republics should not lead to a resumption of a traditional zero-sum game between Russia and the United States. Instead of competition for dominance, Russia and the West should combine efforts in Central Asia to prevent emergence of radical Islamic regimes with terrorist connections. By acting cautiously as it identifies the next target, the United States can not only mollify its European allies but reinforce to the Putin government that Russian cooperation in Central Asia will contribute to everyone’s security, including its own.

**Proliferation of Weapons of Mass Destruction:** For the West, the Gulf contains some unfinished business — the effort to force Saddam Hussein to abandon Iraq’s efforts to acquire WMD. But whether this issue, and that of proliferation generally, should be connected to the counter-terrorism campaign is a matter of considerable dispute among the coalition.<sup>20</sup> For the United States, the concern is that a “rogue

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<sup>20</sup> For a more detailed discussion of the issue of WMD-terrorism linkage, as well as of the impact of the war on terrorism on

regime” might either turn over WMD to a terrorist group or assist it in developing such weapons. Thus, it seems prudent to restrain — by any means necessary — the WMD capacity of states such as Iraq, which are known to view the West with hostility.

For the Europeans, it is not so clear that state-based proliferation is likely to spill over into terrorists’ hands. Now that the Taliban government has been destroyed, few states remain that sponsor terrorists, and on their own, terrorists are seen as unlikely to succeed in developing WMD, except for some crude chemical and biological weapons. Thus, if there is any role for the counter-terrorist campaign in relation to WMD, it should focus on preventing the development of CB capabilities. As for Iraq, the threat of proliferation is seen as very real, but it is not an issue for the counter-terrorist coalition. Instead, the emphasis, in the European view, should be on securing an agreement so that UN inspectors may return to Iraq. A premature military confrontation between Iraq and the West would run the risk of destabilizing the entire region, as Europeans see no credible successor regime in the wings.

As for the Russians, they have long-standing ties with Saddam Hussein’s regime and have not always paid much attention to the threat of proliferation.<sup>21</sup> It is a mistake to see Russian relations with Iraq as merely economic in importance, while ignoring the political and security implications. Russia should take care to prevent its economic interests in Iraq from becoming a major obstacle to improvement of its relations with the West and cooperate more with UN actions to ensure that no sensitive technology or weapons get into the wrong hands. But the West must also acknowledge that Russia has very real interests that have guided its relations with Iraq, and the West cannot insist that they simply be ignored. There are signs of progress — in early April, the United States lifted restrictions on Russian contracts with Iraq worth more than \$200 million. This followed Russian approval of a list of goods that can be sold to Iraq.<sup>22</sup> A more substantial issue is the approximately \$8 billion in Iraqi debt held by Russia.<sup>23</sup> If the West insists that Russia take a more active stance against Iraqi proliferation — as it should — then it should also be prepared to assist Russia in coping with any nonpayment of debt and in preventing the leakage of materials and technology from its own nuclear weapons complex.

Despite these differences, the United States, Europe, and Russia clearly agree that proliferation is a danger. Exactly how to stop proliferation, and particularly to prevent terrorist groups from developing biological and chemical capabilities, should be the subject of an on-going and intensive trilateral discussion focused not on new treaties or institutions, but on assessing and tracking capabilities, especially of non-state actors. Increased intelligence sharing should be coupled with a promise from all parties that the data be regarded seriously in devising a response. The Russians should make clear their lack of toleration for proliferation, even at the cost of lucrative contracts. Their diplomatic leverage in the region should also be recognized, and used when appropriate. As for Iraq, it should be recognized that a premature military response would shake the coalition. Instead, Europe, the United States, and Russia should push aggressively to obtain agreement for the UN inspectors to return to Iraq, with the

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arms control in general, see Gilles Andréani, “Fighting Terrorism and WMD Proliferation after September 11: What Can We Achieve Together?” pp. 64-65 below.

<sup>21</sup> For an examination of Russian policy towards WMD proliferation and the impact of the changing strategic nuclear framework, see Sergey Rogov, “The Window of Opportunity in Russian-Western Relations,” pp. 74-76 below.

<sup>22</sup> “Block on Russia’s Iraq Contracts Lifted,” *Financial Times*, April 3, 2002. Under the UN’s oil-for-food program, which governs commerce with Iraq, any Security Council member can block a contract for products sold to Iraq.

<sup>23</sup> “U.S., Russia Seek Deal on ‘Smart’ Iraq Sanctions,” Reuters, February 6, 2002, viewed at [www.globalpolicy.org](http://www.globalpolicy.org).

clear threat that if that effort fails, more drastic measures, including perhaps the use of force, will then be merited. It is through this step-by-step approach that Russia can contribute most effectively to fighting proliferation and become more engaged with the West.

**Iran:** For some time, the United States, Europe, and Russia have pursued different policies toward Iran, based on very different philosophies about dealing with radical states. For the most part, the United States has remained aloof. It has acknowledged the presence of moderates in the regime, but with few exceptions has not sought to relax the barriers it constructed after the Iranian revolution. Since September, the United States has sought to raise awareness of Iran's WMD program, arguing that the government should be isolated until certain activities cease. The Europeans, on the other hand, have pursued a policy of "critical engagement," based on a distinction between cooperating with the moderate elements in the government, while avoiding the conservative mullahs. A number of European companies have also pursued extensive economic interests in Iran, especially in the oil industry. In the winter of 2001-2002, the European Commission was authorized to begin negotiations for a Partnership and Cooperation Agreement with Iran, a clear sign that constructive engagement would continue, despite the hardening U.S. attitude to the country. As with Iraq, Russia has generally viewed Iran as an economic opportunity, with not enough concern for the consequences.

It is past time for Russia to become engaged in western efforts to steer Iran into a more responsible course. Although European and U.S. officials have disagreed about the means, they have generally agreed on the goals they are seeking in Iran: a democratic, prosperous state that does not foster Islamic extremism or develop WMD. A trilateral U.S.-Europe-Russia discussion of Iran, including a sharing of data on its WMD programs, would be an important first step toward developing a coherent set of strategies. This is not to say that all policies must be harmonized; on the contrary, there is something to be said for the "good cop, bad cop" routine. However, there should be some minimum baseline of acceptable behavior, particularly regarding proliferation. For such a strategy to be effective, Russia must be part of this effort. It is in Russian interests to use its diplomatic leverage and curtail its economic enterprises to impress Iran with the seriousness of the issue. Only by assisting in the western cause will Russia find itself truly moving toward integration into the West.

### *Conclusions*

- The campaign against terrorism has presented Russia and the West with a common enemy, and thus some significant opportunities to collaborate in addressing global threats. But while alignment with the western anti-terrorism campaign is a necessary condition for Russia's progressive inclusion in western institutions and coalitions, it is not a sufficient one.
- The campaign against terrorism has also brought to the fore some issues on which it is not simply a question of integrating Russia with the West, but also harmonizing or reconciling the very disparate views of the United States and Europe on Iraq, Iran, and the Middle East.
- Russia has made a significant shift toward the West by allowing U.S. troops to be based in the CIS, but this is not a stable situation and could be upset if the war against terrorism heads in a direction that President Putin cannot support.

- Russia can bring considerable diplomatic resources that could be useful in strengthening the non-proliferation regime. But neither Russia nor the West have done enough in this area, sometimes allowing special interests to prevail or failing to coordinate their positions. Lack of such coordination on this issue may become one of the biggest obstacles to Russia's integration with the West.

### ***Recommendations***

- The next steps in the U.S.-led campaign against terrorism should be based on careful consideration of the data, including increased sharing of intelligence, and close consultation among U.S., European, and Russian decision-makers. Because such cooperation will be especially important concerning Central Asia, serious consideration should be given to establishing an anti-terrorism coordination process focused on that region.
- The United States, Europe, and Russia should push for the readmission of the UN inspectors into Iraq, but with the explicit understanding, made clear to the Iraqis, that if that does not work, stronger measures, including the use of force, would be justified and appropriate to enforce the UN Security Council resolutions, and would be supported by the European and Russian governments.
- Russia should strengthen its mechanisms to control the export of sensitive technologies. There is a need for a more coordinated approach to prevent WMD proliferation, and the West should offer to provide the support needed to help Russian promises in this area become reality. Cooperative threat reduction efforts should be reinforced, and the Europeans should undertake a more active role in this area, either through their own program or in coordination with U.S. efforts.

## **Bringing Russia into the West**

The aftermath of September 11 offers some powerful opportunities for the United States, Europe, and Russia to work together against a common enemy, and perhaps most importantly, has generated significant political will to bring Russia closer to the West. But serious obstacles to that integration still exist, ranging from conflicts over specific issues to differences over basic priorities. It is not at all clear that the United States and Europe can overcome their current disagreements over the future of NATO and the next steps in the anti-terrorist campaign in order to focus on relations with Russia. Nor is it clear that the Russian government can undertake the reforms required, both in the domestic economy and in foreign policy, to make integration with the West both possible and effective. But to succeed in bringing Russia into the West, all parties will have to tackle these challenges while also seeking opportunities to build enhanced engagement. In sum, although all recognize the long-term advantages of a closer relationship between Russia and the West, moving forward with this task during the next three to five years will be difficult.

If Russia is to move into the global economy, it will have to undertake significant internal reforms, while the West offers specific, targeted assistance. To bring Russia into a new Euro-Atlantic security

framework will require a radically new relationship between Russia and NATO, while also involving further reform of NATO itself, so that its mission and structure no longer reflect the Cold War, but instead the new international environment. Finally, if Russia, the United States, and Europe are to be effective in addressing global challenges, such as terrorism and proliferation of WMD, all parties will have to focus on the specific next steps required to achieve their aims. Russia in particular will have to shift its behavior toward some states, but in return should be recognized by the West as a valuable partner in these efforts.

Under the best of circumstances, the integration of Russia into the West would be an arduous and complex task. The campaign against terrorism has raised the stakes considerably, making this an undertaking both more difficult and more important. Yet there is no choice but to go forward. Bringing Russia into the West will encourage further development of the reforms and stability already achieved in Russia. It will also benefit the West, by enhancing stability in Europe and by bringing a potentially valuable ally whole-heartedly into the fight against terrorism and proliferation. Thus, despite the obstacles that lie before them and the frustrations they will encounter, the United States, Europe, and Russia have much to gain by establishing an effective and genuine trilateral partnership. Building this partnership will be a process, taking many years, if not decades. It will require many changes from both Russia and the West. But that process must start now, using the new window of opportunity. The next several months will be critical in launching this effort, which will benefit all three parties — Russia, the United States, and Europe.



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# **The Future of Russia-West Relations**

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Papers from a trilateral conference  
Sponsored by  
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# The Broader Process of Economic Reform and Russia-West Cooperation on Economic Issues

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By Ognian N. Hishow<sup>24</sup>

## Definition of the Problem

After arduous reforms and turbulence in the 1990s, Russia's economy picked up in the fall of 1998 and has continued to grow rapidly since. This good performance has raised hopes that the country is about to overcome the severe decline of the past and to catch up with the industrialized world. While the reform pace under Yeltsin was slow, Vladimir Putin symbolizes a vigorous move toward a better budget revenue performance, an improved banking system, actual land reform, and reduced corruption. However, a question remains: is Putin an astute reformer, or is he simply lucky to have been in the right place at the right time?

The latter possibility cannot be ruled out. While Russia is experiencing a typical early transition recovery, there is no guarantee against a new slump. With the wisdom of hindsight gained from observing other emerging markets (e.g. Poland or the Czech Republic) one can expect a similar slowdown in Russia as well unless additional reforms keep the economy on track.

So the first question should perhaps be about growth prospects in both the middle and long run. How can more savings and investment be encouraged, in order to raise the capital per worker and thus to generate growth? What must be done to avoid dependence on export demand and to reduce the economy's vulnerability to external shocks?

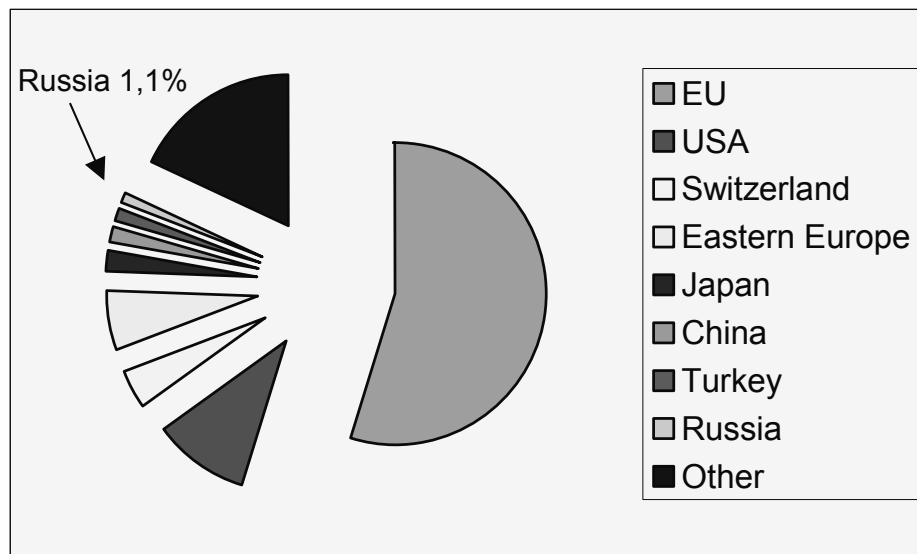
Secondly, how are western interests defined beyond the general consensus that an economically firm Russia is good for stability in Eurasia? On the one hand, Moscow faces financial challenges in the years to come. With a liability portfolio of roughly \$135 billion it is one of the world's biggest debtors. Prime Minister Kasyanov claims the Paris Club should write off its receivables to foster the recovery. While the United States (for political reasons) tends to favor the idea, Germany (Moscow's biggest lender) fiercely rejects any such thought.

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On the other hand, Russia's importance as a trade partner lags far behind expectations. Germany's goods and services turnover with the Russian Federation accounts for about 2 to 3 percent of its total foreign trade turnover with only a sluggish increase. Austria, eighteen times smaller in population, imports almost five times more German goods than Russia (see Diagram 1). Several central European emerging markets outpace Moscow too, including Hungary, Poland, and the Czech Republic — the latter two by nearly double. The conclusion: a healthy Russia benefits Eurasian peace, but is of lesser importance to western economies, since it will take the country a long time to approach the per capita income of the rich world.

**Diagram 1: Breakdown of German Exports by Country**

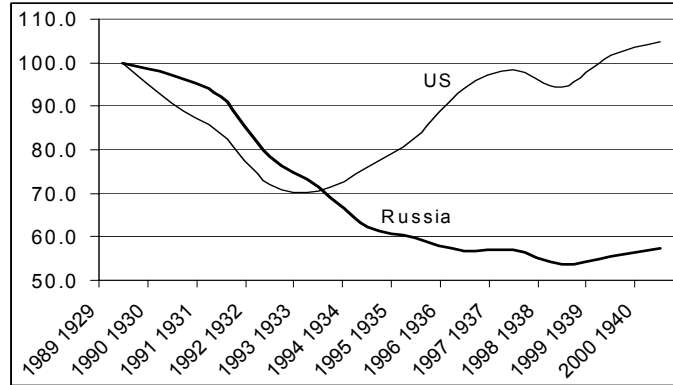


Source: Federal Office of Statistics, Wiesbaden

## A Continued Lack of Sustained Growth

In the late nineties Russia set out to rebuild its economy. To understand the work ahead, one might compare the Russian depression with another benchmark event in economic history — the Great Depression in the United States (see Diagram 2). In America, real output collapsed less than in Russia, and while it took the United States just four years to offset the output losses, Russia will need longer because of lower growth rates.

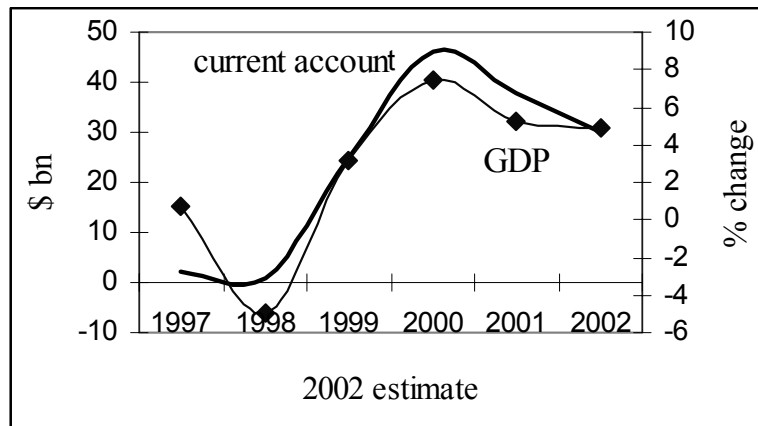
**Diagram 2: Output index in Russia 1989-2000 and the United States 1929-1940**



Sources: Government of the Russian Federation, Russian Economic Trends, Southampton, various issues Table 1; U.S. Department of Commerce, The National Income and Product Accounts, various issues.

Russia has succeeded, however, in leveraging the improved demand-side conditions to achieve more output. The economy started to grow after export demand recovered dramatically — at its peak, export reached 40 percent of the output — due to improved terms of trade in the late nineties. (Diagram 3 displays an apparent link between current account improvement and output recovery.)

**Diagram 3: Current account, \$ billion, and real GDP, year-on-year percentage change**



Source: Goskomstat

The trade exposure suggests why Russia does not yet enjoy sustained growth: with net exports of some 12.6 percent of GDP (in 2001) crumbling oil and gas prices might cut aggregate demand by at least four to five percentage points, and domestic demand expansion at the same rate will be necessary to make it up. However, it is hard to keep domestic demand unchanged, since investment demand is likely to respond by also contracting. In any case, the high growth rates of the last few years are a thing of the past. Moreover, price fluctuations in the oil and gas sector make output fluctuate too: if Brent crude average is \$22.5 per barrel, nominal GDP in dollar terms will be \$362.4 billion in 2002. If the average is \$17.5 per barrel it will be less — by about \$333.9 billion<sup>25</sup> — which is a difference of 8.53 percent.

### **Growth Versus Proper Money Supply**

Compared with other economies in transition, the money to GDP ratio in Russia of about 16 percent is low. In Hungary and Poland it is approaching 60 percent, while exceeding 80 percent in the OECD countries. The ratio indicates the grade of monetization of the economy, and the ability of the banking system to create quasi-money via domestic credit supply. This ability proves crucial, because a strong link exists between money demand/supply and output. A weak money supply leaves the economy starving for cash and facing a downturn.

In Russia, commercial banks lend only reluctantly, and the monetary base remains close to the money stock.<sup>26</sup> In 2001, the share of long- and medium-term credits decreased and accounted for only 15.4 percent of all credits to the private sector. Because creditor risks are still too high, commercial banks continue to refrain from long-term lending to the private sector, fearing difficulties in dealing with collateral and with recovering loans that have gone bad.

But why do firms fail to service their liabilities? Almost 36 percent of the firms produce with negative returns, yet seem in no hurry to match costs and revenues. Either the management is able to persuade a bank to extend money by bribery and personal connections, or it simply relies on a permanent bail-out for political reasons. This creates a vicious cycle in which the credit crunch caused by a paralyzed banking system plays a central role. As deposits are unwillingly made and credit is barely being extended, the money multiplier, which is the money stock to monetary base ratio, remains almost five times smaller than in the West.

Surprisingly, Russia's growth recently outperformed growth in the West, which seemingly refutes the link between strong credit expansion and strong GDP outcome. Indeed, starting from a low point, the economy may be able to grow without bank credit for a while. But with investment demand growing, the weak banking system will increasingly cause a credit crunch and thus discourage future growth. Even if the Central Bank stands ready to inject cash into the system, this will only cause more inflation. The strong position of the borrower torpedoes the monetary policy of the Central Bank and weakens the banking system through payment standstill. More money cannot eliminate the liquidity trap as long

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<sup>25</sup> Source: Brunswik UB Warburg Investment bank.

<sup>26</sup> The monetary base is roughly the currency in circulation. The money stock consists of the currency in circulation plus checking and various saving deposits.

as the culprit — the bail-out mentality — is politically tolerated. Strengthening the rule of law is an important priority.

### **Outsized Current Account Surpluses**

During the nineties Russia ran modest net exports, although these have soared in the last two years, reaching almost 18.5 and 12.6 percent of GDP in 2000 and 2001, respectively. Despite some expected decline in 2002, they promise to remain high, contributing to high inflation rates. However, Russia should reduce her external position to underpin the medium term growth prospects, and not just for price stability reasons. The lesser the current account balance, the larger the amount left to invest in capital goods, and thus the higher the growth rate. With a gross capital investment of some 16 percent of GDP, the country cannot catch up at a reasonable pace. Russia diverts about 5 to 6 percent from output by lending abroad (constituted mostly of capital flight in the range of at least \$15 billion). Channeling a big portion of the overall savings into the current account is a sign of a lack of confidence in economic prosperity. Moscow should add that amount to the investment already in place in order to rebuild the capital stock. Because the capital stock to GDP ratio hovers between 2.5 and 3.0, current net investment is roughly only 3 percent of the capital stock.<sup>27</sup> It will theoretically take at least 20 years to double the capital stock and thus the output — a daunting prospect considering the low per capita income of just \$4,000 to \$5,000 compared with \$26,000 in the West. At fault is an investment environment which causes capital to stay out of the country (by underreporting; only half of the nominal export revenues are being surrendered to the monetary authorities) or to seek higher returns abroad as foreign direct investment. Other things being equal, the prospect is grim: with a low investment to output ratio the economy will soon reach a low, steady level of capital with low per capita output and income.<sup>28</sup>

Another drawback results from foreign exchange entering the country and translating into inflation. The monetary base has been growing at a pace of up to 60 percent a year since 1998 and has been keeping the rate of inflation high. For debt service and terms of trade reasons, the Central Bank of Russia pursues a dollar-pegged exchange rate policy, which causes the real exchange rate to appreciate. Rising costs and prices in ruble terms harm import-competing Russian manufacturers and tend to redistribute demand at the expense of domestic goods, and thus to jeopardize growth. A similar effect derives from fast growing real wages in the core sectors of the economy, since soaring labor unit costs undermine the benefit of the previous real labor cost depreciation (Diagram 4)

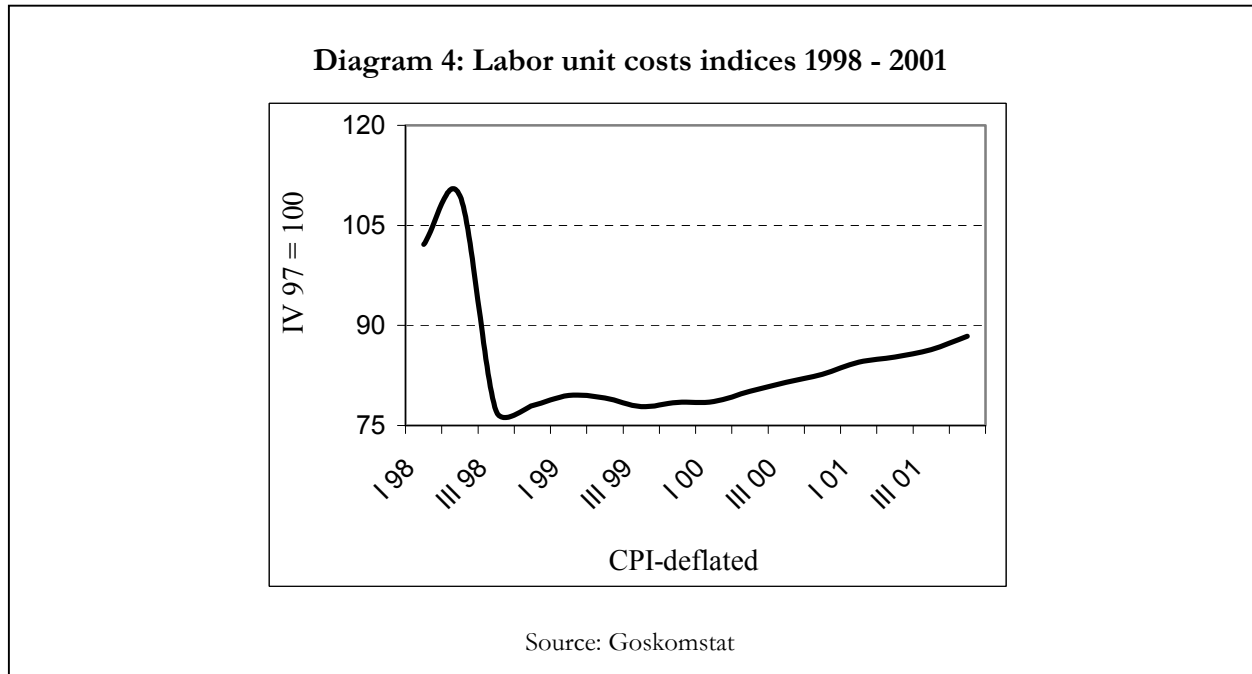
Finally, large current account surpluses bar more foreign direct investment (FDI) and thus the know-how and technology transfer which the economy desperately needs. This explains why Russia continues to attract just a fraction of the FDI amount entering some Central European emerging markets. With a positive capital account, there is no basis for much capital import unless the (illegal) capital flight

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<sup>27</sup> 16 percent of GDP gross investment and GDP/capital stock ratio of 2.5 yields a 6.4 percent gross investment to capital stock ratio. Net investment is roughly 3.4 percent if reinvestment (amortization) is 3 percent a year.

<sup>28</sup> Current growth rate is likely to flatten out unless more investment is in place. Only so the economy may reach a new (higher) steady state, and so on.

accelerates even more. Instead, the authorities should encourage capital goods imports to lay a solid ground for sustained growth.



### External Debt: Debt Service Relief is Possible, Forgiveness Out of the Question

As outlined above, western economic interests — beyond the general consensus that a healthy Russia is good for stability in Eurasia — focus heavily on the issue of Moscow's foreign debt. During perestroika the former Soviet Union already realized its incapacity to service the hard currency denominated debt, and this problem became acute after the economic collapse in the early 1990s. Thus, the only way out of the mess was to restructure, and this was what Moscow did. Between 1993 and 1996, Russia signed four rescheduling agreements with the Paris Club. While the first three provided only temporary relief to Russian finances, the agreement of April 1996 covers \$38.5 billion to be repaid within 25 years with a generous grace period of six years. Following this success, about 600 London Club member banks signed a similar agreement on October 6, 1997, allowing Russia to stretch servicing of \$32.5 billion in debt over 25 years, starting after a grace period of six years. But only two years later, Russia pressed for another debt relief agreement and persuaded the London Club to write-off one-third of the due debt in February 2000, as well as to accept an interest service reduction. In total, Russia saved some \$70 billion in the nineties thanks to reduced debt service — an amount roughly equal to a quarter of its 2001 nominal GDP. In sum, the West's contribution to the balance of payments was significant, which refutes claims that western indifference has aggravated the crisis in Russia.

Meanwhile, strong growth and surging budget revenues allowed fears of default to recede. Russia's debt service to export revenues ratio now lies below the World Bank's benchmark of 30 percent, and



assuming that oil prices remain fairly high and stable, will continue to be well under that level in the years to come (column 5 of Table 1). More severe constraints are likely in the case of a radical oil price decline, leaving growth, exports, and the budget short of the flexibility needed to meet the regular debt service payments (here calculated on a \$15 per barrel basis: Table 1, columns 6 and 8.) Only in such a situation should Moscow's request for rescheduling be considered by the Paris Club of official lenders.

**Table 1: Debt service indicators**

1	2	3	4	5	6	7	8
year	debt service \$ billion	export at \$22 per barrel \$ billion	export at \$15 per barrel \$ billion	debt service to export at \$22 per barrel, %	debt service to export at \$15 per barrel, %	debt service to budget expenditures (on \$22 basis) %	debt service to budget expenditures* (on \$15 basis) %
2000	10,7	105,6	105,6	10,1	10,1	23,5	23,5
2001	11,8	103	103	11,5	11,5	22,2	22,2
2002*	11,9	103	56,65	11,6	21,0	17,4	22,8
2003*	19	102	56,1	18,6	33,9	24,7	31,7
2004*	19,5	103	56,6	18,9	34,4	22,7	28,9
2005*	19,5	105	57,7	18,6	33,8	21,0	26,5

\*estimate. \*\* lower share of budget expenditures at the GDP assumed.

Source: Goskomstat, Handelsblatt, Neue Zürcher Zeitung.

Arguments in favor of writing off the Soviet Union's debt lack conviction, because there is no evidence that Russian growth will suffer from continuing debt service.<sup>29</sup> A write-off would be a bad solution, as this would mean that Russia is allowed to misuse its political leverage to affect its position as a debtor. Another draw-back is the associated cost, which would fall on western taxpayers. Finally, an important tool to keep Moscow on track to continue economic reforms and democratization — the financial stick and carrot — will be abandoned.

## WTO Accession Benefits Both Sides

Being a member of the WTO is not unusual. Out of almost 200 sovereign countries in the world, 144 are already members of the WTO. Besides the Baltic states, three former Soviet republics boast membership, while others have received observer status. Astonishingly, large countries and big economies sometimes find it harder to get in — it took China sixteen years. Russia does not want to match this record, even

<sup>29</sup> Write-off advocates point to a possible domestic demand loss as a result of the loan repayments. Following Ohlin, however, the money repaid by Russia will cause an income increase in the West leading to more demand for Russian goods and thus to economic growth.

though the pros and cons of accession more or less balance each other. While President Putin and government officials welcome membership, skepticism is articulated in academic circles and in business. Critics deem WTO membership an armageddon which would eventually leave Russia short of national companies, banks, and entrepreneurs.

Intuitively, since Europe currently suffers from a weak external position in trade with Moscow, it might be anxious to see Russian markets opened for competitors from abroad. Conversely, from a Russian viewpoint, it appears reasonable, in the short run at least, to erect barriers to protect the core sectors and infant industries in order to allow them to cope with higher western productivity and quality standards.

Sadly, infant industries rarely grow up, and protected sectors hardly adapt to a more competitive environment. Why should the commercial banks, which have enjoyed protection for 10 years, become more efficient in the foreseeable future?<sup>30</sup> On balance, particular disadvantages cease to weigh as heavily as at a first glance. Since it is a widely held belief that tariffs protect from competition while WTO accession implies an open economy, Russians fear domestic goods will be crowded out by imports, leading to mass unemployment. Actually, the average Russian tariff rates range between 7 percent and 15 percent, and are rarely applied, thus up to 50 percent of all imports evade customs duties. Besides, tariff rates are negotiable at the time of accession, and WTO members may temporarily raise tariffs or use non-tariff measures subject to valid economic justification. Compared with the ruble's real exchange rate, the impact of tariffs on the competitiveness of Russian businesses is relatively weak, even if enforced with 100 percent efficiency.<sup>31</sup> Moreover, tariffs tend to have a negative distributive effect, since they keep relative prices in the protected sectors high, thus weakening the sectors without protection. Only after the removal of the tariffs might equilibrium be restored.

A strong pro-WTO argument results from examining Russian exports interests. Currently, almost 100 anti-dumping measures are in place in the EU, the United States and Japan, and also in Egypt, India, China, Turkey, South Korea, Thailand, South Africa, and the Philippines. With WTO accession looming, a number of trade disputes have been successfully resolved. An agreement has been signed between the Russian and U.S. ministries of trade on suspension of anti-dumping investigations into Russian steel products, safeguarding entry to the U.S. market of 1.7 million tons of steel.<sup>32</sup> WTO membership will allow Russia to improve the status of its exports, thus reducing the anti-dumping damage and increasing business opportunities for those firms that are not currently exporting.

Looking at the broader picture, membership entails a positive external stimulus for a new business and administrative culture. Foreigners can play an important role. Russian oil firms are valued in the stock market at four times their earnings, while the major internationals are valued at twelve times their earnings.<sup>33</sup> To close the gap, Russia must open up the economy by enacting legislation to protect long-term investment. In the past, market entrants were often overwhelmed by corruption and red tape. In 1997, BP put \$ 571 million into Sidanco and then wrote off half of the amount barely a year later. Foreigners strongly insist on production sharing contracts (PSA) signed by the government to secure

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<sup>30</sup> Center for Economic and Financial Research, *Russia in the WTO: Myths and Reality*, in: [www.cefir.ru](http://www.cefir.ru), p. 3.

<sup>31</sup> *Ibid.*, p. 7.

<sup>32</sup> *Russian Economic Report*, January 2002, in: [www.worldbank.org.ru](http://www.worldbank.org.ru).

<sup>33</sup> "The sweet smell of Russian oil," *The Financial Times*, 02/01/2002, p. 13.

their investment. But the state gave only three PSAs in the 1990s, and even with these coveted contracts, foreign partners are plagued by red tape and bureaucracy. (For example, an obscure law forbids foreigners from owning pipelines in Russia.<sup>34</sup>) For the same reason, Germany's Wintershall AG pulled back last year from a joint exploration project with Gazprom in the Prirazlomnoye offshore gas field.

"Internationalization" of Russia's market will help to identify the shortcomings which hamper attempts at establishing a business environment more conducive to growth. Moreover, openness will allow disputes to be handled constructively. It is in Russia's interest to improve the notoriously inconsistent interpretation of laws, as firms in Russia are forced to devote significantly higher resources to accounting activities than companies in the developed world. It is the West's most urgent interest to bring Russian practices closer to European standards and regulations. That should lead to enhanced trade and investment, as many of the bilateral problems are to be found in non-tariff barriers<sup>35</sup>

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<sup>34</sup> "Foreign oil producers revive Russian-investment projects," *The Wall Street Journal*, 12/13/2001, p. 3.

<sup>35</sup> "EU looks for sense in Russia trade dialogue," in: [www.ft.com](http://www.ft.com), 12/12/01, p. 10.



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# Russia in the Globalizing Economy

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By Ivan Ivanov<sup>36</sup>

Despite a certain slowdown in global business, the ongoing process of globalization continues to be a leading trend. Even the world's largest economies are increasingly responsive to outside stimuli affecting their growth and, alternatively, vulnerable to external shocks, for example extreme fluctuations in energy prices. Following the lead of transnational corporations, foreign markets are now invaded by medium-sized and even small enterprises. The flow of goods and capital are feeling the effects not only around the globe, but also around the clock, and short-term financial transactions alone are estimated to be \$1 trillion a day.

The Russian Federation is not exempted from these developments. The official goal of our reformers is an open market economy, and this model is gradually taking shape. The export share of GNP is now over 20 percent — higher than, for example, in the United States, Japan or India. Some industries like energy, ferrous metals, aluminum, fertilizers, and timber perform as primarily export-oriented industries, selling about 50-70 percent of their output abroad, and imports cover about 40 percent of domestic consumer demand. The DFI are still lagging behind these developments, but are quite noticeable in some sectors like tobacco, paper, cosmetics, food, pharmaceuticals, etc.

It is clear that this export orientation and import dependence are partly the temporary results of a contraction in internal industrial consumption in the midst of the crisis of the 1990s, making exports crucial, and accordingly an overdimensional imports is the outcome of an inadequate domestic supplies because of the same crisis factors. To this end, Russian enterprises were able only partly to use the “greenhouse” effect of the 1998 devaluation of the ruble to reestablish themselves in the domestic markets. However, the long-term trends are in favor of an exposure of the Russian economy to the international trade and investment system.

This new business thinking has manifested itself now in a rapprochement between Russia and the World Trade Organization (WTO) and in seeking new horizons like an emerging common economic space for greater Europe. With all this in mind, the Russian concept of globalization is nevertheless somewhat different from other versions.

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## Russian Views of Globalization

As a large country, Russia relies on economic growth primarily in its vast domestic market with due respect to national economic security, particularly because foreign stimuli are as yet volatile and far from perfect. Macroeconomically, the high energy prices provided about half of our growth in 2000, but only about 20 percent in 2001. The excessive exporting of the 1990s is also receding because of revived domestic demand, which is forcing the government to restrict the exportation of energy and energy derivatives.

Secondly, Russia is not entirely satisfied with the current trend in globalization. We believe that this process can no longer depend on the gap in development between rich and poor countries, because it may eventually undermine the world business architecture as a whole. As the UN Millennium declaration stresses, we need a partnership, not disconcerted action with the WTO as the engine of development. Many Russian observers are not inclined to view antiglobalists as merely street hooligans; there are some seeds of truth in their slogans, deserving of dialogue with globalists.

Russia has therefore decided to support the actions of the World Bank, the Paris Club and the WTO in favor of development of the South, despite the fact that they are rather burdensome for our budget and BoP, since Russia's major debtors are amongst the least developed countries. In addition to debt relief we also allow their products into our markets duty-free.

While undertaking these measures, Russia is nevertheless of the opinion that schemes such as HIPS should not in general reduce the credit capabilities of the World Bank for other potential borrowers or make it more expensive for poor countries to borrow. Neither does Russia believe that it should participate in any similar schemes extending to borrowers in the Commonwealth of Independent States (CIS), who were already relieved of all their Soviet foreign debt that was assumed by Russia. In the end, the North and the South should be partners — not merely donor and client — and the onus of moving towards greater development is upon each individual country. As stated in the draft of the Monterrey Conference (March 18-22, 2002), “each country has primary responsibility for its own economic and social development and the role of national policies and development strategies cannot be overemphasized.”

It is also crucial to ensure that the task of leading globalization is not left solely to transnational corporations, as important as their input in the process may be. Governments, international bodies and non-governmental organizations should also be involved, ensuring that the globalization process is more balanced and socially secure.

When analyzing the modern international experience, we see two different levels of, or formulas for, globalization. The first is a universal one — represented, for example, by a growing WTO that liberalizes economic cooperation throughout the world. Russia welcomes the outcome of the Doha WTO Ministerial conference, which has managed to hammer out reasonable compromises between developed and developing countries in lieu of previous confrontations, and this increases Russia's determination to join the organization.

The second means by which globalization can progress is regionally and subregionally, through trade policy unions with limited memberships like the Andean Pact, MERCOSUR, NAFTA, or the EC. APEC is now a genuine aggregation of bilateral free trade zones as well.

### **Russia's Place in a Greater Europe**

This is why Russia is serious about regional integration in Europe and concerned about the future of the European Community. It is a major trade and investment partner with whom Russia shares a common history and geographical proximity, and cooperation is therefore in our best interests.

Russia understands the challenges facing the EC in the years to come, namely ongoing enlargement and the related institutional reform that will be necessary in order to make a larger community manageable. We accept that enlargement is a matter to be decided between the EU and each individual candidate country, and expect only to have legitimate Russian interests taken into account in that process. These are the fifteen Russian “concerns” officially tabled in Brussels on the issue as a whole and four specifically pertaining to Kaliningrad as a Russian enclave someday to be surrounded by EU territory. There is already deep dialogue on energy cooperation and promising collaboration on science, technology, and stopping crime. On the basis of this forward movement there is discussion of “a common European economic space” between the EU and Russia, and a mandate from Russian leadership to explore this idea.

However, the Russian position in this area needs some clarification. It is true that Russia feels itself to be already a part of a larger Europe — and is ready as such to contribute to solutions for some of the continent-wide problems, specifically in energy supply, science, ecology, law enforcement, and, above all, security. For Russia, a “common European economic space” is interlocked with a “common security space” in Europe and we are prepared to go as far as a military-technical cooperation with the “European Defense Identity.”

At the same time, Russia is a global and Eurasian power and obviously cannot concentrate all its attention exclusively on Europe. Therefore, while stressing our European identity we prefer to have a free hand in our policy towards and cooperation with all regions, including Asia, the United States, and, above all, the CIS. Thus our relations with the EU can be expected to be only contractual, and not institutional, i.e. involving membership or association. This is not a limitation, however, as even a recent treaty such as the PCA still offers many untapped opportunities for cooperation — at least 64 of its norms still await implementation.

Practically, the concept of a “common economic space” can only be realized after Russia accession to the WTO. The test for the EU's determination to achieve this goal will be in establishing a mutually acceptable understanding with Russia in regards to its enlargement concerns, since the candidate countries will be a part of this “space” as well. Despite political statements, real progress in this area is still limited. The EU Commission has been slow to undertake the necessary consultations, and reluctant even to schedule them before enlargement actually takes place, an attitude that is exacerbating dissatisfaction in Russia. It is true, that Parties proclaimed an enlargement has to be matched by a

further growth in business cooperation between Russia, new member countries and the enlarged EU as a whole. But the devil is in the details and this detalization has not as yet even started in legal terms.

There is also a misperception that “common space” implies a total harmonization of Russian business law with “*aquis communautaire*.” Some parts of U.S., Japanese, and other law systems may also be useful in making our legislation more sophisticated. In other words, Russia prefers to preserve its own legal system as part of its unique identity. It would be rather absurd to expect, for example, that the Russian far East or far North (neighboring the United States, Japan, and China) should be governed by *aquis communautaires*. Also, *aquis* are *international* law, governing interstate relations, and are subsequently inadequate for the needs of *domestic* law in Russia. Consequently, the harmonization under review may be meaningful in limited spheres only (technical standards, ecology, customs, certification, diplomas, et al.) and generally might be understood as an EU-Russian agreement to respect the norms and principles of the WTO.

While assessing intraeuropean affairs, one should not miss their broader international environment. The modern multipolar world is interrelated and there are several tripartite and multilateral combinations deserving of attention. The first is the EU-United States-Russia relationship. A dialogue among the three was institutionalized two years ago in Lisbon, but later fragmented into bilateral ties. This fragmentation seems unwarranted, because the parties have a great deal to discuss trilaterally and if the governments concerned are not yet ready to resume such discussion, then this may be done and ought to be done by the relevant research centers.



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# Beyond Revival: Building a More Competitive Russia in the Long Term

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By Astrid S. Tuminez<sup>37</sup>

Russia's ruble devaluation, default on debt, and market crash in August of 1998 led many observers to predict further chaos, dislocation, and doom in the Russian economy and in Russian society. Fortunately, those predictions proved largely to be wrong. Although the events of August 1998 created many difficulties for the Russian population, nonetheless the worst scenarios for the country did not materialize. Instead, in the last three years, the devaluation of the ruble, soaring energy prices, a measure of political stability, and a new impetus for economic reform have contributed to Russian economic growth and revived interest in Russia among international investors. While positive economic indicators in Russia should be appropriately recognized, Russia's long-term economic stability and prosperity cannot be taken for granted. Many problems remain to be fixed. What has happened in recent years may aptly be called a revival of the Russian economy, but will this revival continue in the next five to ten years? What further steps must be implemented to safeguard Russia's economic future and ensure that Russia becomes a more durably competitive player in the global economy?

Russia's future prosperity is clearly linked to its successful integration into the global economy. Integration implies that Russia become a full-fledged player in global trade and finance, play by the same rules as other countries, and benefit from the open flow of goods and capital between itself and its global partners. But before integration can happen and Russia can reap its benefits, Russian policymakers must take further steps to strengthen their country's industrial, financial and economic system. This paper will briefly address four issues that directly impinge on the prospects of Russia's successful, long-term integration into the global economy. These are: 1) corporate governance, 2) banking reform, 3) debt restructuring, and 4) membership in the World Trade Organization (WTO).

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## Corporate Governance

Corporate governance has been a very popular theme in Russia since 1998. Not only has it been the focus of numerous conferences, business gatherings, and press write-ups, but it has actually made a mark in the practice of a few Russian corporations. In fact, companies that had been notorious in ignoring shareholder rights before 1998 (e.g., oil companies Yukos and Sibneft, and energy transmission company UES), have adopted codes of corporate governance, enhanced the transparency of their business operations, and been rewarded by the market as a result. The prominence of corporate governance became even more apparent late last year, when the Russian Federal Commission for the Securities Market (FCSM), under the leadership of Igor Kostikov, completed the exercise of drafting Russia's first-ever Code of Corporate Governance. The FCSM actively solicited the input of international and Russian regulatory experts, officials, investors, and business people in drafting the Code, and conducted a broad educational campaign within Russia to generate support for the document. Among the issues that the Code addresses are management compensation, duties of Boards of Directors, management obligations to shareholders, rules of disclosure, and dividend payments. Although adherence to the Code is voluntary, the Russian government has officially approved the document and Prime Minister Mikhail Kasyanov has urged Russian managers to comply with its provisions. A revised law on joint stock companies, the regulatory oversight of the FCSM, and reporting by non-governmental watchdog organizations should also enhance potential compliance to the Code in the future.

The weakness of corporate governance has been a key stumbling block in making Russia a more competitive global player, and has discouraged investment from both domestic and foreign sources. Many investors viewed, and continue to view, the corporate environment in Russia as one of corruption, opacity, and blatant disregard for the rights of investors and shareholders. The stereotype, in the words of one journalist, is that of a “cult of thievery” in the country. While many problems of corporate governance persist, recent developments indicate a level of improved understanding of, and adherence to, sound management practices and fair protection of investor rights. A few Russian companies have strengthened their accounting standards, published regular reports to shareholders, notified investors of annual meetings, and paid dividends. Several corporations have also voluntarily subjected themselves to the scrutiny of U.S.-based ratings agency, Standard and Poor's, to determine how they rate on a scale measuring corporate governance.

The new focus on corporate governance in Russia is helpful, but more remains to be done. The value of most Russian corporations remains dormant because investors impose a huge discount for shoddy governance practices. To illustrate, the total market capitalization of Russia is only \$88 billion—smaller than the market value of the largest western corporations (e.g., Citigroup has a market capitalization of \$255 billion). The biggest Russian company, gas behemoth Gazprom, is valued at only \$14 billion.<sup>38</sup> Most investment in Russia's public companies remains speculative, with very few long-term investors willing to make solid asset allocations to Russia. Further, because of poor corporate governance, most Russian firms cannot raise debt financing or can do so only at high cost. Until investors are convinced that corporate governance practices have improved in a more permanent way, Russian companies will continue to suffer from low valuations and the inability to attract capital cheaply and easily. Without

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<sup>38</sup> Figures for Gazprom and total Russian market capitalization are as of January 31, 2002; Citigroup's market capitalization is as of February 1, 2002.

sound and reliable corporate governance, Russia will remain in the periphery of the developed global economy.

The current momentum on improving corporate governance should be sustained. International institutions and individuals from both the public and private sectors have made important contributions to the drafting and launch of Russia's Code of Corporate Governance, and they should continue to emphasize the importance of adherence to the Code as they deal with Russian business and government leaders. Inside Russia, the FCSM should be strengthened and given more resources for its campaign to educate managers, officials, and the public throughout Russia on the meaning and value of corporate governance. A more robust mechanism should eventually be developed to enforce corporate governance. This could be a mix that includes the FCSM, law and order agencies, and private watchdog organizations (e.g., ratings agencies or their equivalent).

## **Banking Reform**

Three and a half years after the collapse of the Russian market in 1998, Russia's banking system still remains to be reformed. Unfortunately, the events of 1998 did not lead to a restructuring of the banking system or to tighter rules that would have strengthened Russia's credit culture. Unlike in the developed economies, where the central role of banks is financial intermediation (i.e., mobilizing savings and directing them to the highest-value uses—for example, as loans to individual entrepreneurs or to industrial enterprises), Russian banks do minimal retail business. Except for the state-owned Sberbank, most Russian banks take very few deposits and make few loans. In fact, lending by Russian banks amounts to a mere 10-12 percent of GDP level (compared with 80-120 percent for western European countries). Many Russian banks function instead as treasury arms of larger organizations, providers of short-term credit, vehicles for executing payments, and facilitators of capital flight. Before the financial collapse of August 1998, Russian banks were also primary investors in government bonds. After the devaluation of 1998, several of Russia's largest banks stripped assets and transferred them to new entities, defrauding depositors and cheating creditors in the process. Sadly, Russian authorities have not prosecuted any of these managers or demanded an accounting of their financial dealings in the wake of the 1998 crash.

Much like it was in the days of communism, the state continues to play an overwhelming and inappropriate role in Russia's banking sector. Conflicts of interest abound. For example, the Central Bank of Russia (CBR), the key regulator in the banking system, is also the largest shareholder in the biggest banks, particularly Sberbank (58 percent CBR-owned) and Vneshtorgbank (96 percent CBR-owned). Sberbank controls 80 percent of retail deposits in Russia (the second largest retail bank, Alfa Bank, only has 4 percent of deposits by comparison), and no other institution could realistically compete with Sberbank's Soviet-inherited, monopoly position. The government also offers deposit insurance for Sberbank, but not for other banking institutions. As for the implementation of banking reform, resources are meager and it remains unclear as to which institution has the final authority for implementation. The CBR has been disappointing in this regard, and so have other institutions such as ARCO (Agency for Restructuring of Credit Organizations, set up in the aftermath of August 1998). Going forward, the Putin government's ultimate success in economic reform will depend in large part on how it deals with banking reform.

Without a genuine, trustworthy, and competitive banking sector, Russia cannot be well integrated into the developed global economy. Financial flows will be hampered and the availability of capital inside Russia will remain limited. In turn, innovation and growth will be stunted. Russian policymakers as well as officials from international institutions and partner governments (including the United States) over the last three years have spouted abundant rhetoric on, and sponsored numerous analyses of, Russian banking reform. However, all these activities have only had a marginal impact on actual restructuring of Russia's banking sector. Numerous proposals have been generated on such key issues as banking regulation, deposit insurance, improved accounting standards, more robust capital requirements, the lifting of restrictions on foreign banks, limiting the state's role in the banking system, and so on. But, to date, no systematic attempt is apparent to implement the best of these proposals. A stronger push for banking reform is clearly needed from the Putin government. There is already ongoing assistance from international institutions and governments on reforming Russia's banking system, and more resources (including private ones) may be harnessed if and when the Russian government's resolve to implement effective banking reform becomes more apparent.

In a recent study, experts from The World Bank emphasized that Russia's long-term growth will require a base that is broader than that currently provided by the behemoths of Russian industry, concentrated in the natural resources (i.e., oil and gas) sector. In fact, 70 percent of Russia's export revenues come from this sector, which also attracts a disproportionate amount of capital investment. While Russia is fortunate in having tremendous extractive assets, nonetheless long-term, sustained growth for such a large country requires diversification. Small and medium businesses, in particular, will be important engines of growth and wealth creation. At the moment, as many as 80 percent of these businesses face huge difficulties in raising capital on the local financial market because of Russia's archaic banking system. This situation is unlikely to change unless more steps are taken to build a trustworthy and competitive Russian banking system.

## **Debt Restructuring**

Russia has fulfilled its post-Soviet debt obligations since 1998, while not receiving any new financial aid from the IMF since 1999. Soviet-era commercial debt has been restructured via agreements with the London Club, including key agreements in 2000 on rescheduling and reduction of principal and interest rates. By one calculation, Russia received debt forgiveness amounting to 52 percent when debt reduction, lower interest rates, and the grace period on principal payments for London Club debt are all taken into account. At the moment, the Russian Ministry of Finance is working on the details of a swap proposal that will allow holders of Soviet-era commercial debt to exchange the paper they hold for a mix of cash and Russian Eurobonds with variable maturities.

A thornier issue is Russia's sovereign debt to the Paris Club of creditors, amounting to approximately \$40 billion. Russian officials, including President Putin and Prime Minister Kasyanov, have asked for debt forgiveness from the Paris Club, akin to the deal Russia reached with the London Club, but thus far no agreement has been reached. A particularly important player in ongoing negotiations is Germany, which holds close to half of Russia's Paris Club debt. Germany's official stance is that Russia can afford to service its sovereign debt and any debt forgiveness would impose too large a burden on Germany.

Russia has responsibly managed its external debt burden in the past three years, and its debt profile has improved markedly since 1998. External debt as a percentage of GDP has dropped from almost 90 percent in 1999 to 47 percent in 2001, and the ratio of total maturing debt to foreign exchange reserves dropped from 214 percent in 1999 to 37 percent in 2001. Because of high oil prices and economic growth, Russia has even been able to pre-pay some of its debt in the past year. It has also established a Reserve Fund to deal with an expected spike in debt payments in 2003. Experts on Russian debt believe that Russia should be able to meet its debt obligations in 2002, but the payment spike anticipated in 2003 could be problematic. In particular, if oil prices dive, there is a risk that Russia may be unable to meet approximately \$19 billion of debt payments coming due in 2003.

Russia arguably has the means necessary to meet its sovereign debt obligations, including privatization of huge stakes that the government still owns in some of the country's most lucrative enterprises. However, one can make a case for western creditors to consider forgiving some of Russia's debt and restructuring the rest. First, Russia's debt burden is huge relative to its federal budget. To illustrate, Russia's federal budget for 2002 is \$60 billion, while debt service obligations amount to \$14 billion. Money used to pay the debt is money taken from potential spending for programs that could be more important to the long-term health of Russia's population and economy. Debt forgiveness could be worthwhile *if* it is linked to a concrete program of economic reform and other domestic spending in such areas as education, health, and job training. Second, Russian cooperation on security issues including non-proliferation and anti-terrorism has become extremely important in the wake of the September 11 terrorist attacks on the United States. Proposals that link Russian debt forgiveness with greater cooperation on security issues are timely and worthy of serious consideration by Russia's sovereign debtors. Finally, precedents of debt forgiveness to enhance economic reform and security cooperation do exist and should be considered when western creditors look at Russia's case. For example, the United States forgave 70 percent of Poland's debt in 1991 because Poland's debt burden was unmanageable and U.S. policymakers viewed debt relief as a measure that would alleviate Polish difficulties as they made the transition to a market economy. The United States also forgave \$7 billion of Egypt's military debt in 1991 to repay Egypt for its support in the Persian Gulf War, and forgave Jordan's debt of \$700 million in 1994 to reward Jordan for its stabilizing role in the Middle East conflict.

## **Membership in the WTO**

An important aspect of Russia's integration in the global economy is membership in key international institutions. High on the list is the World Trade Organization (WTO), whose 144 members set the regime governing international trade. Russia began negotiations to join WTO in 1993 and these negotiations have intensified since Putin became president in 2000. In the aftermath of the September 11 terrorist attacks on the United States and Russia's subsequent cooperation with the United States in its war against terrorism, there has been plenty of talk regarding accelerated Russian entry into WTO. U.S. government officials, including George Bush, have indicated their support for this accelerated process. While U.S. support can be helpful, it is insufficient to determine Russian membership in WTO. What is even more important is the speed and extent of domestic reform—specifically, actions by Russian policymakers to bring their country's formal trade-related legislation and informal practices in line with WTO rules.

The Russian government has already taken significant steps to respond to the formal requirements of WTO membership. These include pushing forward revised legislation, responding to questions raised by the organization's Working Party on Russian accession, submitting offers on trade access in goods and services, and negotiating bilaterally with WTO members who have directly expressed concerns regarding access to Russia's market. A detailed program is also in place covering further steps that Russian policymakers must implement to qualify for WTO membership. All these efforts to date are commendable. But hurdles remain on the horizon. Foremost is the absence of reform in the banking sector, which is a concern to WTO members. As long as the state plays as large a role as it currently does in the banking industry and as long as protectionist measures dominate, Russia will be viewed as non-compliant to WTO rules. Another problem is the issue of informal subsidies in the Russian economy, including non-competitive energy prices, weak bankruptcy practices, and the use of barter for trade and taxes. Improvements have occurred in these areas, but more needs to be done to assuage the concerns of WTO members. A third problem area is corporate governance, which has been discussed above. Finally, Russia must also address weaknesses in its system with regards to property rights, contract enforcement, and other judiciary-related matters.

Russia loses an estimated \$3 billion in trade yearly because of non-membership in WTO. Thus, membership has the potential to contribute directly to Russia's enhanced economic performance. Other long-term benefits of membership would be increased international investor confidence in the Russian market, a more significant Russian voice in setting the rules that govern global trade, and likely improvements in goods and services inside Russia as its own market becomes more open to outside competition.

## **Recommendations and Conclusions**

Policy recommendations, especially for Russia, are outlined in the preceding paragraphs. For emphasis, some of these recommendations are repeated below, and others suggested for U.S. and Russian policymakers.

### ***Corporate Governance***

United States: According to the head of the FCSM, Japan's prodding in the EBRD had much to do with the Russians' launching their effort to draft a Corporate Code of Governance. In the spirit of their Japanese counterparts, U.S. policymakers should dedicate resources to helping the FCSM in its next, logical step: to educate regional politicians, business leaders, and the public on corporate governance. The FCSM has received numerous requests from governors and others in the regions to conduct educational and training seminars on corporate governance, but the FCSM's resources to do so are limited. With assistance from the U.S., the campaign to train and educate could advance much further, thus helping build a potentially more effective constituency for Russian corporate governance.

Russia: President Putin needs to express explicit support for the new Code of Corporate Governance. Putin is an authoritative leader and, at this early stage of developing good corporate governance in Russia, his overt support would be invaluable. Next, the government should consider measures to help

the formation of independent ratings agencies in Russia and these agencies should be given formal powers in the context of Russia's capital market.

### ***Banking Reform***

United States: Banking reform should become a key item on the agenda of the newly formed Russian-American Business Dialogue. Specifically, U.S. policymakers and private sector representatives should encourage their Russian counterparts to take concrete steps to facilitate broader operations by foreign commercial banks inside Russia (e.g., lifting restrictions on the number of branches foreign banks can have). Russians do not trust their banking institutions for the most part, and U.S. and other solid foreign banking institutions may provide the shortcut towards cultivating popular trust in banks inside Russia.

Russia: The government should proceed more quickly with plans to divest itself of major holdings in the banking sector, including Sberbank, Vneshtorgbank, and others. Along with divestiture, the CBR has to take steps to become a more independent and effective regulatory body.

### ***Debt***

United States: In the aftermath of September 11, U.S. policymakers should encourage their German partners to explore limited debt forgiveness for Russia as an option. Debt forgiveness should only happen if linked to specific and continued Russian cooperation on anti-terrorism and further advancement of the agenda for Russian economic reform.

Russia: Russian policymakers should propose a concrete program of steps they would implement in such areas as non-proliferation, anti-terrorist intelligence gathering, education, job training and others in exchange for debt forgiveness. This program should not be overly ambitious, but must be credibly limited, specific, and measurable.

### ***WTO***

United States: The United States should follow up on its rhetoric of support for accelerated Russian accession into WTO by: 1) increasing technical assistance to specific Russian efforts to meet WTO requirements, and 2) working with its allies to enhance support for Russian membership. Russia is unlikely to meet WTO requirements perfectly, especially as these have become more stringent over time. However, it would be useful for the United States to work with other countries toward an understanding of the minimum hurdles Russia must pass in order to get the necessary support from current WTO members.

Russia: There is some debate within Russia on the pros and cons of WTO membership, and Russian policymakers need to explain more clearly and effectively why WTO membership would benefit the country as a long-term player in the global economy. Strong domestic support inside Russia for WTO membership would help ensure that, when accession actually happens, its operational aspects will be implemented in a sustained manner.

Russian integration into the global economy is a worthy goal. More than a decade after the collapse of the Soviet Union, it has become apparent that the road towards attaining that goal is neither simple nor easy. This brief essay has addressed a few key issues pertaining to the building of a more robust and competitive Russian economy in the long-term. As Russian policymakers, working at home and with global partners, address these issues, their success will likely mean a better life for most Russian citizens and a true normalization of Russia's relations with the rest of the world.



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# Building a Euro-Atlantic Security Framework: A European View

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**By Benoit d'Aboville<sup>39</sup>**

Russia and the West have a very full agenda for 2002, and the decisions they will make will have far-reaching consequences. In part, these decisions will determine whether or not a potential post-September 11 strategic shift truly materializes. However, this agenda is built on assumptions and questions which are not yet fully answered. Furthermore, a range of issues currently being given a great deal of importance could, if not resolved, put at risk the longer-term building of this relationship.

I would like to mention a few of these challenges or issues. The first one is the bilateral summit in Moscow in May where there will be a decision as to whether or not Russia will accept the new kind of strategic framework based on significant nuclear reductions that the United States is proposing. Of course, when one says the “new strategic framework,” it is understood that there will be a lot of old things with the new. We can’t avoid some measures that have been developing over a long period of time; for instance, the Russian-American negotiations from the START period. However, one aspect of the new strategic framework which the Europeans should consider, is that for the first time the link between the United States and Europe inherent in extended deterrence will be redirected. In this way, this so-called new flexibility is a reversal of the U.S. endeavors in the 1980s and 1990s. This is the logical consequence of two things: first, ballistic missile defense, and second, the test ban treaty which, ratified or not, will still be implemented. Another element to observe at the summit is of course ballistic missile defense following U.S. withdrawal from the ABM treaty — what will be Russia’s attitude towards this? There is also a third issue that is of interest to Europe, involving a possible economic element in the U.S.-Russian negotiations, especially debt. Russian debt is an issue particularly for Germany, which is a big creditor.

The second challenge to watch is the institutional evolution of the relationship between NATO and Russia. NATO hopes to introduce its proposal for a new institutional relationship just this week to the Russians. We hope that by the Reykjavik meeting, we will have put this to the North Atlantic Council. Of course, there will be a lot of criticism of the “old wine in a new bottle” variety. However, we should remind critics that this wine has in fact never been tested because cooperation was stopped during the

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Kosovo crisis in 1999, and we have yet to retry the experiment with a full-capacity NATO-Russia relationship.

In fact, there are already pre-set limits which will restrain any institutional framework. The first one is that Russia does not want to be an ally — Russia has no interest in participating in Article 5 activities. This is their official position, and NATO is equally hesitant in that it doesn't want to be constrained as a functioning alliance. It is also important that a NATO-Russia framework not function as a precondition or compensation for the enlargement of the alliance. So we have to compromise, and I think we have found a formula to navigate around these limitations.

However, rather than focusing on these institutional considerations, NATO and Russia should instead put their energies towards developing joint cooperation on concrete projects. There is a wide range of ideas currently under examination for possible collaboration. Basically they fall into three categories: crisis management, including peacekeeping; military cooperation and defense modernization; and developing a common approach to new threats, including terrorism and weapons proliferation.

The next item on the agenda is, the Prague summit, at which enlargement will be a key topic. There are several lessons to consider from the previous round of enlargement. The first is that Russian security was not threatened by the extension of NATO to Central Europe, a point accepted by the current Russian leadership. Second, Russian policies towards the new members in Central Europe have not been particularly beneficial for the region, in fact they have been rather counter-productive to Russian interests, and this has also been recognized on the Russian side. And third, enlargement into the Baltic region will certainly make the relationship between those countries and Russia a great deal easier, and may lead to solutions for some legitimate raised by Moscow issues such as the status of Russian-speaking minorities.

Another important issue is the Balkans. This has been both a bone of contention between NATO and Russia, but also an area of political cooperation. There are Russian forces collaborating with NATO in Bosnia as well as Kosovo.

Aside from these challenges, there are still many areas in which western policies have not yet been fully thought out. First, is there a real strategy against terrorism which will be developed with Russian cooperation? Were the events of September 11 and the subsequent actions in Afghanistan a catalyst for developing a new direction with Russia or simply the extension of a previous policy? Second, is the military option in the operation against terrorism a necessity and if so, will that affect the overall stability of the new policy toward Russia? Third, is Russia truly such an important and valuable partner for the West in areas beyond the fight against terrorism and non-proliferation? This point may in fact require more debate. At the strategic level, Russia's military budget is only one-tenth of that of the United States. Economic interests are even less clear-cut: France, for instance, has more trade with Poland than with Russia, a situation that is not likely to change very quickly. Will Russia provide useful assistance on the issue of non-proliferation, and particularly in the cases of Iraq and Iran?

A final consideration: what are the issues that are currently interfering with the preparation for this new NATO-Russia framework? Within the Russia-NATO dialogue, the Russians have, so far, presented two contradictory positions: they have proposed both to consultation at twenty, and to maintain a dialogue at

nineteen plus one. This is clearly incompatible because it would mean both equal standing with full NATO members (at twenty) and the option of sitting at the table as separate and independent from the alliance. If we are to progress, this needs to be resolved.



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# Building a Euro-Atlantic Security Framework: A U.S. View

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By Jan M. Lodal<sup>40</sup>

While the destruction of the World Trade Center and the attack on the Pentagon have profoundly changed attitudes related to Euro-Atlantic security, the Bush Administration has paid relatively little attention to a “Euro-Atlantic Security Framework” outside the immediate tactical considerations related to the aftermath of September 11. As a result, it is difficult to speak of an “American view” at this juncture. But some elements seem relatively clear.

Whatever new Euro-Atlantic security framework comes to pass, it will almost certainly be built on the foundation of the “new NATO.” NATO has demonstrated its ability to adapt to the radical changes in world affairs of the last 15 years. NATO has created the Partnership for Peace, modified its strategy, admitted new members, accommodated a democratizing Russia, organized its first military operations in Bosnia and Kosovo, and adapted its understanding of the core Article 5 commitment to the terrorist attacks on the United States. It is inconceivable that a new institution could be created from scratch that could be more effective than an evolving NATO. Thus, the next Euro-Atlantic security framework will either be based on NATO, or will have to exist without a separate multilateral institutional framework.

As the European Union gradually develops its voice in foreign and security policy, it will play an increasing role in NATO affairs. But to substitute the block vote of the EU for the individual votes of the member states would be to destroy the delicate process by which the Alliance develops the consensus required for the Alliance to operate. If the EU block comes to the table with a position that has of necessity already been heavily compromised, there will be little room for further compromise with the non-EU members. The result would be to transform NATO into little more than a political forum (an outcome welcomed by some, including many Russians). NATO will continue to be effective only if it remains primarily a security organization, able to use combined military force when necessary.

NATO as nothing more than a “political forum” would be redundant with (and probably less effective than) other existing multilateral institutions and diplomatic channels. The likely outcome of such a transformation would be to drive the United States further away from its traditional focus on Europe as its key security partner and thus undermine the very notion of a Euro-Atlantic security framework. But

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NATO has always had multiple purposes and has needed to adapt to an ever-changing world political environment. Prior to the Korean War and subsequent buildup of Soviet and American forces in the center of Europe, NATO was heavily focused on internal security and stability in Europe; only later did military preparedness against an invasion threat dominate.<sup>41</sup> The challenge now will be to continue the history of successful adaptation in light of the quite immediate threat of further terrorist attacks and rapid WMD proliferation that could lead to WMD in the hands of terrorists.

The following sections summarize the challenges NATO must deal with if it is to succeed as the basis for a new Euro-Atlantic security framework and recommends specific solutions for each. Many of these challenges existed in some form before September 11, and much of the necessary change to the Alliance was already underway. But the need to deal with these challenges has been intensified and the possible outcomes are more limited now that the nature of the new post Cold-War threats have been demonstrated.

## **Strategy**

The threat of invasion of NATO territory remains the official basis for NATO's military strategy and thus for its elaborate military planning process. But this threat is gone. A new strategic concept must be developed in which "non invasion" threats, including terrorism, WMD proliferation, and the underlying causes of failed states and autocratic regimes, are given top prominence. These threats cannot be met militarily without effective "out of area" operations, which have been resisted by Europe (in no small measure because of Europe's lack of ability to carry them out). Nor can NATO as an institution ignore the essentiality of preventive actions, some of which must be backed up by military force or the credible threat to use military force if necessary. Despite the relatively recent revision of the Strategic Concept (1999), the Prague summit this year should mandate a new strategy review, with Partnership for Peace members, and Russia individually, given a meaningful consultative role.

## **Nuclear Forces**

A major element of a new NATO strategic concept should be a complete overhaul of nuclear strategy. NATO's nuclear strategy retains the primary concept of maintaining a capability to use nuclear weapons first to stop an invasion of NATO territory, hoping to thereby to deter any possible attempt at an invasion. But there is no remaining credible invasion threat to NATO. The first use of nuclear forces should remain an option only if necessary to preempt a WMD attack against a NATO member; NATO should forswear the use of nuclear forces against a conventional military attack. Maintaining a first-use capability against a possible invader requires a level of alert and a quantity of nuclear forces that will continue to impede the evolution of political relations with Russia. This relationship must eventually become largely "non-nuclear," much as the relationship among the United States, Britain, and France is today, if the final vestiges of Cold War hostility are to be eliminated permitting Russia to be fully integrated into European institutions.

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<sup>41</sup> See Anthony Forster and William Wallace, "What is NATO for", *Survival* vol. 43, no. 4 (Winter 2001), pp. 111-114, for a comprehensive summary of the history of NATO adaption.

Such an evolution will take at least a decade and is largely dependent on the evolution of bilateral U.S./Russia nuclear relations. The United States must drop “damage limiting” and other aspects of its nuclear posture to permit much deeper reductions in its nuclear forces, and Russia has to give up its aspirations to use nuclear weapons to maintain “great power” status. France must abandon its traditional nuclear strategy, which has been based on the threat of first use. These are significant challenges. But the NATO strategy of potential first-use remains an impediment to the evolution of relations with Russia and should be abandoned now.

## **Missile Defenses**

The issue of the proper role and size of future ballistic missile defenses (BMD) has been seen as primarily impacting U.S./Russian bilateral relations. But it should also be dealt with in the NATO context. Both current NATO members and Russia will face threats from ballistic missiles in the future and have a legitimate need for defenses. BMD technology is far from perfected, and a large ballistic missile attack will be able to defeat any deployed defense for the foreseeable future. Thus, ballistic missile defenses need not and should not negate the deterrent forces of the existing nuclear powers as these forces are reduced from Cold War levels. A NATO strategic concept incorporating this position could facilitate settling the issue with Russia.

## **Conventional Force Capabilities**

The current ESDP objectives are probably not adequate to give Europe enough capability to operate alongside the United States in operations such as the one recently completed in Afghanistan. Yet meeting even these modest objectives has proved to be an insurmountable challenge to date.

The problems with Europe’s military forces have been well documented. These forces lack essential mobility and interoperability, and they are years behind the U.S. in adopting new information technologies to improve their command, control, communications, and intelligence. Only the British have reconfigured their air power to focus on precision guided munitions, including the use of special forces as ground-based target spotters. Europeans have only begun to equip their forces with the GPS guided weapons that were so effective in both Kosovo and Afghanistan.

America’s conventional forces also need significant transformation away from today’s heavy forces designed to meet a worldwide Soviet threat. But America’s problem is considerably different from Europe’s. The United States must retain sufficient heavy forces to deal with the continuing ground-based invasion threat posed by Iraq and North Korea, as well as the more remote possibility of other armored invasion threats to America’s allies and security partners. Furthermore, significant portions of the U.S. military already have the mobility and sustainability to deal with the new threats, as was demonstrated by the dramatic success of operations in both Kosovo and Afghanistan. The challenge for the U.S. military is more one of force mix and efficiency than one of absolute capability.

NATO’s military capabilities must not evolve into a high-tech, high-mobility American component and a low-tech, low-mobility European component. Unless Europe can dramatically modernize and reform

its military capabilities, there will be few if any circumstances in which the United States will not prefer to carry out military operations largely on its own, defeating the very purpose of the Alliance and eventually undermining its utility. This does not rule out a reasonable “division of responsibilities” in specific circumstances such as peacekeeping operations in the Balkans, which are already largely carried out by European forces. But Europe must develop a basic capability to participate in significant “out of area” combined operations, either alone or with U.S. forces.

Much of the U.S. debate on the ESDP has focused on the desirability of a separate EU multinational capability that could operate largely outside the NATO framework. But any effective European force designed to operate out-of-area will be inherently capable of operating at least to some extent on its own. The United States should encourage this movement and put its diplomatic effort not on limiting the ESDP, but rather on insuring its interoperability and adequate capability.

### **Terrorism and WMD Proliferation**

While NATO’s strategic concept is being revised and European forces are enhanced and restructured, efforts should be accelerated to give NATO an operational role against terrorism – particularly against the threat from WMD. The immediate challenge will be to develop a consensus on NATO participation in the next stage of the war against al-Qaeda. The Bush administration has made clear its determination to carry the war beyond Afghanistan, while Russia and the other Europeans have opposed expanding military action. There is in principle no disagreement that Saddam must open all his facilities to highly intrusive and no-notice WMD inspections. Perhaps the threat of unilateral military action by the United States will motivate a concerted clampdown on Saddam’s regime and avert a replay of the Gulf War. But as is almost always the case, non-military coercion is unlikely to be effective unless the target (Iraq in this case, particularly its military and clan leaders) is convinced that it will face devastating military action if it does not comply.

A NATO ultimatum to this effect, especially if joined by Russia, would be the most likely non-military solution to the next phase of the war on terrorism. If the Europeans (including Russia) could accept this conclusion, not only could an otherwise likely war in the Gulf be averted, but the basis for a new Euro-Atlantic approach to WMD proliferation and state acquiescence of terrorist organizations would have been established.

Ultimately, the war on terrorism and WMD proliferation cannot be won by unilateral U.S. actions. Only local intelligence and law enforcement entities have any chance of tracking down the easy-to-hide biological and chemical WMD facilities that can use commercial technology to create terror weapons. Only local agencies can track down and infiltrate al-Qaeda cells.

Even vastly improved law enforcement and intelligence will have great difficulty in many parts of the world eliminating terrorists with the goals of al-Qaeda and the willingness to go to their deaths for their cause. It will be necessary to deal with the many root causes that have been identified, beginning with state’s tolerance of institutions that educate entire generations to hate western liberal values and reverent suicide terrorists who kill innocent civilians. NATO will need to play a role in developing a Euro/Atlantic consensus on the specific measures that should be taken to bring these changes about.



## Expansion

This fall in Prague, NATO will decide to admit more new members. The criteria that were established six years ago continue to govern this process. But these criteria are largely irrelevant to the current situation, which calls for getting the expansion issue settled once and for all so that NATO can complete its transformation and become the basis of the new Euro-Atlantic security framework. Thus, all reasonably qualified candidates, including all three Baltic states, should be admitted this fall. This does not mean that there can thereafter be no further expansion, and of course the issue of Russia's possible future membership will remain. But once the Baltics, Slovenia, Slovakia, Romania, and Bulgaria are admitted, the basic transformation of the old NATO/Warsaw Pact system into a new unified NATO will have been essentially settled.

## NATO/Russia

NATO's expansion will demand new institutional arrangements to insure that the traditional consensus rules do not impede decision-making when the major states agree on collective action. New approaches to decision making will also be necessary to accommodate a growing relationship with Russia. Adjustments should be begun now, years before serious consideration is given to Russia's actual membership in NATO. If new arrangements can be established and proved to work in practice, they could remove one of the main impediments to Russian membership.

As discussed above, Russia's full participation in NATO must also await the transformation of the Cold War nuclear relationship into one much closer to "minimum deterrence." (Nuclear abolition may never be possible and would be an unrealistic goal to set for now.)

The most immediate challenge to Russia's full integration into a new Euro-Atlantic security framework is its full acceptance of responsibility to do everything possible to stop WMD proliferation. This will mean foregoing some lucrative commercial transactions and holding the states behind proliferation and terrorism responsible, even if it is necessary, *in extremis*, to use military force against states that do not comply. Such an approach is far from the habits of Russian agencies who inherited the attitudes (and many of the personnel) of their Soviet predecessors, continuing to do business as usual with Iran, Iraq, and other potential proliferators.

If these issues can be resolved, NATO can be the core around which a new Euro-Atlantic security framework can be built – one that moves as rapidly as possible to a non-nuclear relationship between all the major powers, emphasizes counter-terrorism until the scourge is removed, and makes a major contribution to providing safety from the threat of weapons of mass destruction.



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# Building a Euro-Atlantic Security Framework: A Russian View

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By Vitaly Zhurkin<sup>42</sup>

In order to present the prevailing Russian thinking on Euro-Atlantic security problems, which are not always uniform and at times even rather disorderly, it is probably worthwhile to divide my observations into two categories: certainties, and uncertainties. Using this approach, certainties will consist of well-known events and phenomena, and uncertainties of areas requiring greater clarity and resolution in order to build a healthy Euro-Atlantic security framework.

## **Euro-Atlantic Security: Certainties**

First, following the tragedy of September 11, a new convergence between Russia and the West (both the United States and the European Union) took shape. One may argue as to how radical and/or serious this new stage in international relations may be, and question whether a new stage truly exists and if so, how long-term and durable it may prove to be. However, these questions are mostly of a theoretical nature, and the answer to them will come in time. The fact remains that these horrible attacks against New York and Washington led Russia to a new turn in its relations with the West. This was partly the result of the psychological shock of an act of international terrorism of this magnitude. Partly, it was the result of quite rational decisions by the Russian president and the majority of the political leadership. In any case, the new partnership with the West has serious public and political support, if not entirely unanimous.

Second, Russia's participation in the antiterrorist campaign against al-Qaida and the Taliban created an unprecedented culture of interaction between the various branches of government — ministries, departments and services — including security and intelligence structures. Today this newly created network of interrelationships is at a crossroads: it can grow further or begin to fade away. The existing framework, the clear potential and the unquestionably positive results point obviously in the first of these directions.

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Third, while avoiding too hasty a conclusion, one should clearly recognize that relations between Russia and NATO have noticeably mellowed, to say the least. This improvement is still rather shaky, however; there are groups on both sides who look upon it with suspicion rather than expectations. But the potential is there and has a good chance to grow and strengthen.

Last but not least is the interaction which is being planned and realized between Russia and the emerging system of European security and defense policy. In comparison with previous joint Russia-EU actions and decisions, which were worked out over many years, the framework for cooperation in the areas of security and defense were developed and finalized in quite a short period of time. The Russia-EU joint declaration on strengthening their dialogue and cooperation on political and security issues in Europe created a political and legal basis for combined and coordinated actions. Virtually all of the most important aspects of security and defense were included, as well as modalities for Russian contributions to EU crisis management operations.

Naturally, cooperation in such delicate areas will take time and much effort. The European Security and Defense Policy, the creation of a Rapid Reaction Force, and other efforts are still evolving. But concrete decisions have been made by both sides, and most importantly these decisions were made rapidly.

### **Euro-Atlantic Security: Uncertainties**

Unfortunately, the prospects for building a Euro-Atlantic security framework include not only these positive certainties, but also more unpleasant uncertainties. For example, it is still unclear what will be the fate of the new NATO-Russia structure — the Council of 20 — which is supposed to formally institutionalize an effective interaction. It is uncertain when and how it will be instituted, with what functions and what competence. Certainly, the emergence of such a structure may help solve many problems and create a solid base for NATO-Russia cooperation.

The establishment of such a council is not merely an organizational matter. It is an important political and to a large extent international legal undertaking which will promote a new level of Russian participation in the Euro-Atlantic security framework, and a new, more advanced stage in the security relationship between Russia, Europe, and the United States.

The practical details of the council under discussion are less important than the political implications, although both present certain challenges. The full scope of its responsibility is to be worked out by negotiation; it is likely that a compromise will be made involving two or three levels of decision-making, with some decisions to be made jointly and others separately by NATO and Russia respectively. The criteria for situations requiring a high level of joint decision-making should be strictly defined. The scope for shared actions should be initially quite narrow; for example, limited to counter-terrorism initiatives or some other specific actions. Should such collaboration prove successful, the boundaries for joint decision-making may be widened.

The war on terrorism is another uncertain element. Some ambiguity is developing around the antiterrorist coalition regarding its future aims and targets. It is not entirely clear whether the United States will try to repeat the Afghan campaign in another part of the world. If so, will the United States

act unilaterally or together with all or some participants in the current operation in Afghanistan? Will there be any preliminary consultations, and to what extent will the views of other nations be taken into consideration? What will be the role of the UN Security Council, will its approval be sought? These are only a few of the many questions that remain to be answered concerning the war on terrorism — evidence of the high degree of uncertainty with which it is regarded. On the one hand, these questions do not seem likely to shatter the coalition; on the other, it is preferable to eliminate or reduce problems that may arise and weaken the coalition.

Another area of uncertainty is the set of problems and disagreements surrounding NATO enlargement. This is an area in which there has been a great deal of discussion, and the arguments of both sides have been articulated many times.

Additionally, there is reason to be concerned about a certain uneasiness in U.S. (and NATO) attitudes toward the emerging European Security and Defense Policy. While higher officials on both sides periodically express mutual understanding and support, and while both the EU and the United States attempt to overcome problems at practical levels, there is still some discord on both a political and public level. This does not pose a serious threat to the foundations of the EU-NATO-U.S. relationship, which is rooted in the transatlantic alliance, common civilization, and a community of political ideals, but will nonetheless create problems for the further development of the Euro-Atlantic security framework. Although this issue is not directly related to Russia's interests, rifts in relations between the United States and the EU over NATO and ESDP may yet become a factor which could hinder Russia's relations with both. Thus, compromises between all involved are important for the development of an effective Euro-Atlantic security system. Such a system should preferably consist of a network of interlocking, mutually supportive structures including NATO, the EU and ESDP, the OSCE, and other subregional organizations.

Naturally, this brief essay covers only a few elements from the cluster of problems involved in building a Euro-Atlantic security framework. An important condition of the construction of that framework is the transformation of the uncertainties (those explored here as well as others) into certainties which will become the building blocks of Euro-Atlantic security.



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# Fighting Terrorism and WMD Proliferation after September 11: What Can We Achieve Together?

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By Gilles Andréani<sup>43</sup>

The United States, Europe and Russia have stated their intention to work together to fight terrorism and the proliferation of weapons of mass destruction. But as we begin to identify how this can be accomplished, there are a number of questions we must ask — about the true extent of a consensus, the realities of a linkage between terrorism and WMD proliferation, how to clarify the situation in the Middle East, and the overall view for arms control, among others.

## The Post-September 11 Consensus

Is the post-September 11 consensus waning, or is there still the basis for increased cooperation among the United States, Europe, and Russia? I think there is still a large measure of transatlantic agreement, but the opportunity for building a much stronger one was partly lost in the last months of 2001; furthermore, we are now entering a difficult phase as the United States begins defining its mid-term strategy to fight terrorism after its victory in Afghanistan. This process is going to be divisive and frustrating for both Europe and the United States.

There is still an impressive consensus across the Atlantic (including in Russia) that:

- Sept. 11 has presented us with a new, totally unacceptable kind of terrorist threat.
- The answer to that threat includes a qualitatively different and much higher level of international cooperation across a wide spectrum of activities (police, judiciary, intelligence, military, etc.); for the sake of convenience, the Americans have called this increased cooperation a coalition, a concept which has commanded a high level of support and loyalty across the Atlantic.
- U.S. successes in Afghanistan were brought about by a mixture of diplomacy, determined use of force, and moderation, all of which were widely praised.
- Afghanistan is not the end of the road; in particular, a worst-case scenario is that the actors behind the nihilist and politically inchoate kind of terrorism which manifested itself in New York and Washington will acquire access to weapons of mass destruction.

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- Under these circumstances, maintaining the global coalition against terrorism remains a high political priority; disagreements on Middle East policies should not be allowed to stand in the way of that objective.

However, there have also been some lost opportunities:

- The failure of the United States to accommodate even modest or token contributions from allies, which could have cemented western unity and resolve in the fight against terrorism. Allies' contributions were managed as a technical matter to be decided by the military, rather than as a political issue.
- NATO offers were discarded; and disparaging U.S. comments could be heard regarding European contributions, both real and proposed.
- Differences in appreciation for Russia's role across the Atlantic. Whereas the Europeans tended to interpret Russian solidarity after September 11 as a truly strategic move, which should be reflected in a new relationship with NATO or in another fashion, the United States seemed more guarded, even reluctant.
- In this context, withdrawal from the ABM treaty was largely perceived in Europe as an anticlimactic, albeit expected, move by the United States.

Further complications and challenges lie ahead, including:

- Failure on the U.S. side to make even a symbolic use of European offers of military assistance, and failure on the European side even symbolically to reciprocate American mobilization and increase in defense spending, have now paved the way for a return to traditional clichés on both sides: trigger-happy Americans who see only military solutions to complex and multifaceted challenges on the one hand; and complacent or militarily impotent Europeans who leave the fighting to the United States on the other.
- The U.S. position towards the Palestinian-Israeli conflict has changed so that the United States is now widely seen abroad as supporting Israeli Prime Minister Sharon's confrontational instincts, and possibly endorsing his vision of the conflict as just another instance of fighting terrorism, rather than a conflict between two national movements calling for a genuine compromise to achieve peace.
- The designation of Iraq, Iran and North Korea as an 'axis of evil' was criticized in Europe by several administrations as being motivated by either: U.S. domestic politics (Jack Straw); disregard for allies' views (Joschka Fischer); or oversimplification of the issue (Hubert Védrine). The risk that such criticism creates is that the United States may be seen by Europe and Russia as bending the coalition's agenda to accommodate U.S. objectives with respect to Iraq, Iran, or North Korea, which are only indirectly, and possibly not at all, related to the fight against terrorism. Conversely, the Europeans (or some in Europe) may be seen in the United States as frustrating American efforts in that fight. Although the Europeans will want to avoid a war of words with the United States, and to preserve the coalition, this is an election year in France, Germany and the United States, a context not always conducive to verbal restraint.
- As the U.S. definition of phase II now focuses on Iraq, old divides on the issue will resurface. In addition, this will make differences of view on the Palestinian issue more salient, as any military campaign against Iraq will be much more central to Arab opinion and interest than Afghanistan ever was. 'Double standards' and 'linkage' arguments brandished by Iraq in 1990-1991 will again be heard, in a much more favorable context.



- These frictions, and causes for disagreement between the United States, Europe and Russia will be further aggravated by the stance in some U.S. quarters that the United States not only does not need anyone's assistance in the fight against terrorism (which may be militarily correct) but should show less concern with allies' views, since such concern shows a lack of resolve — a view debatable from a U.S. standpoint, and highly contentious from an allied perspective.

This being said, the dominant mood among Europe's leaders remains that they should maintain whatever coalition now exists, and accommodate American preoccupations as much as can be done without compromising important interests of their own. While they may be skeptical about the 'axis of evil,' worried about possible future U.S. actions with regard to Iraq, and distressed by U.S. support for Prime Minister Sharon, they will nonetheless try and avoid unnecessary confrontations with the United States. This does not mean open disagreements will not occur; in fact, they may be even more serious, as a result of having been delayed.

Against this background, what can all three sides do together in the fight against terrorism and in their efforts to curb the proliferation of weapons of mass destruction? The following are not policy prescriptions, but rather suggestions for ways to think about these issues in the months ahead on both sides of the Atlantic. Disagreements are often rooted more in preconceptions, or differences in analyses than in actual policy objectives; and policy prescriptions are likely to be upset by moves from the other side anyway (it may well be that the remnants of al-Qaeda rather than U.S. planners take the initiative in 'phase 2'; or that horrendous losses in civilian lives on either side in the Palestinian-Israeli conflict present us with a totally new political situation in the Middle East.)

### **Terrorism and WMD: Building a Coalition**

As the United States and its allies undertake to fight terrorism and curb WMD proliferation, can differences in threat assessment be effectively managed? One structural problem is the asymmetry in capabilities between the United States and its allies: the U.S. is often in sole possession of information, leaving others the difficult choice to more or less blindly endorse U.S. assessments, or challenge them at the risk of being seen as questioning the Americans' good faith: an example is the U.S. case against Iran as a proliferator of weapons of mass destruction, an accusation which rests mostly on American analysis (and presumably knowledge) of Iranian intentions.

Threat assessments are always sensitive to internal politics (e.g. the Rumsfeld Commission), to one's political enmities or geographical situation (e.g. since 1994, France has been more sensitive to 'Afghan alumni' threat, which they experienced in Algeria, while the United States has been more concerned with Iran.) Over-dramatizing the threat has always been a natural tendency of those in charge of intelligence assessments, sometimes with unexpected results. For example, Iraq's interest in biological weapons was probably stimulated by the conclusion of the biological weapons convention and the attendant open discussion of the lethal potential of those weapons. Secretary Cohen's 'pound of sugar' photography was found in an al-Qaeda compound in Kabul. Needless to say, September 11 has quite justifiably created an atmosphere in the United States where worst-case analysis appears vindicated, and more cautious assessments have been marginalized.

The key issue now will be to find out how much of al-Qaeda remains, and more importantly, if other such groups will emerge and make September 11 the first successful example of a growing 'hyperterrorist threat' or whether it will remain more circumscribed than is generally assumed at present.

At this juncture, a central issue is going to be the respective role of state-sponsors and non-state actors in mass terrorism. Going after states is easier because they offer an opportunity to apply military force, an advantage which may induce planners to inflate threat assessments as they relate to states. But the historical trend is nevertheless one of decline of state-sponsored terrorism. The Taliban's Afghanistan was hardly a functioning state and constituted a unique case in their candid admission of support for a terrorist network such as al-Qaeda. Their defeat will further reinforce the trend and induce would-be providers of support to mass terrorism to abstain or rush for cover. An additional deterrent factor is the post-September 11 anthrax attacks in the United States — the inquiry revealed that particular strains of biological weapons could be traced back to their country of origin, a piece of news which will certainly be heeded by governments tempted to provide that kind of help to terrorist groups. But despite this trend, and additional restraining factors currently at work, the U.S. instinct will naturally be to focus on state sponsors, or accomplices, of terrorism: this instinct may be seen as excessive, or even disingenuous by other nations.

In sum, nothing is more urgent, nor more intrinsically difficult, than the more intense and confident police cooperation, intelligence exchanges, and comparison of threat assessments needed between the United States, various European countries, and Russia.

### **Terrorism and WMD: Assessing Linkage**

When discussing the proliferation of weapons of mass destruction and the fight against terrorism, it is important to consider to what degree they should be seen as a single problem. Conceptually, nothing seems more valid than considering the combination of mass terrorism of the Sept 11 type, and weapons of mass destruction — which provides one of the most frightening scenarios for the future. Indeed, terrorist groups have shown a high degree of interest for WMD. One must distinguish, however, between biological weapons and conventional weapons, which terrorist groups could acquire or produce on their own — at least one, the Aum cult, has used both — from nuclear weapons, which they could only get, or conceivably divert, from states.

Ballistic missiles are a different problem: there is no international consensus to ban them, their possession does not always convey a presumption of evil intent, and they are one of the most unlikely weapons for terrorists because they are cumbersome, visible, and easy to track if used. In the real world, weapons of mass destruction and missiles are overwhelmingly part of state strategies and traditional international security issues. The fight against terrorism should thus induce the United States, Europe, and Russia to enhance their efforts in the non-proliferation field, but in order to keep such efforts distinct from the coalition against terrorism, they should give more attention and resources to cooperative threat reduction schemes of the Nunn-Lugar type, aimed at preventing the diversion of nuclear material, and WMD-related expertise. There is a case, post-September 11, for Europe to invest more in such schemes.

## **The Middle East: Separating the Issues**

Current issues in the Middle East are also sometimes seen as a single problem. Policies for this region are often intertwined, and discussions on the Israeli-Palestinian conflict often include references to Iraq, and vice-versa. Can Iraq, the war against terrorism, and the Israeli-Palestinian conflict be disentangled?

Iraq is rising on the U.S. agenda, as well as on the European and Russian one: it enjoys increased oil revenues, sanctions are being circumvented, the regime has been released from the pressure of arms inspections and shows no sign of coming to terms. On the other hand, Iraq represents only an indirect terrorist threat; essentially because it could provide terrorists with WMD capabilities should it reconstitute them — a slightly farfetched possibility given Saddam Hussein's apparent distance from terrorist activities since 1992. Altogether, there may be good reasons for devising a more effective and united Iraq policy, which could include a combination of more pointed sanctions and a return of arms inspectors, but they are only indirectly related to the fight against terrorism. The main criteria for urgent action remains Iraq's ability to threaten regional stability or to reconstitute meaningful WMD capabilities — both seemingly relatively low right now, but increased oil revenues might change the picture over time. Iraq, the Palestinian-Israeli conflict, and the fight against terrorism are now lumped together in a way not conducive to intellectual clarity or sound policymaking. The peace process is now hostage to extremists on both sides, and the definition of a new policy towards Iraq is bound to be even more difficult if it is conducted within the framework of the war against terrorism and against the background of Arab outrage at Sharon's policies. The issues must be addressed as separate — related to various degrees, but essentially different.

## **Rethinking Arms Control**

What are the implications of the war on terrorism for arms control? Post-September 11, the fall from grace of arms control in U.S. thinking looks more and more entrenched; the Europeans and the Russians can no longer wish it away. Therefore, arms control treaties will continue to be a divisive issue between the United States and the rest of the international community as long as the Americans assess their effectiveness by their ability to constrain ill-intended states, while leaving all U.S. options open. More realistically, these treaties should be seen as fostering the international norm with respect to some categories of weapons, just as the function of laws against theft is not to catch thieves, or prevent theft, but to reflect the consensus of law-abiding citizens that theft is a bad thing.

In this sense, arms control should continue to play an integral part in the fight against proliferation. But progress should be sought less in new enforcement schemes, such as the verification protocol of the Biological Weapons Convention, whose efficiency is dubious and which will be rejected out of hand by the United States anyway, but rather in two other directions. First, we should look for ways to reinforce the international consensus on imposition of penalties for use of biological or conventional weapons, which are the two most likely to be used by terrorists. Second, we should devise ways of expressing commitments of restraint on the use of missiles, an area currently void of any international norm other than the MTCR. What will succeed the ABM Treaty is unclear, but some sort of arrangement should be found that will reassure Russia and China as to the pace and scope of U.S. defensive systems. Finally, an

international norm should be maintained which prevents the permanent deployment of weapons in space.

The war against terrorism will be the dominant framework for U.S. security policy in the months and years ahead. This could be an opportunity for increased cooperation, since Russia, Europe, and the United States essentially have the same interest in fighting this threat, as their post-September 11 attitudes have shown. At the same time, it creates an entirely new situation, where traditional transatlantic institutions and cooperative schemes have been sidelined, and new ones are unlikely to emerge instead. The new security agenda will be U.S.-defined, and will leave very little space for accommodating the views or contributions of others. This may be a defining moment, but it is not one conducive to institution-building or establishing new formal cooperative schemes drawing Russia, the United States, and Europe closer together.

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# The New Trilateral Partnership: Opportunities and Challenges

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By Richard Burt<sup>44</sup>

One of the most interesting aspects of the current discussion is the topic itself — the potential for a trilateral partnership between the United States, Russia, and Europe. To underscore the depth of change since September 11, one need only consider the climate of relations prior to the terrorist attacks. During the decade or so between the fall of the Berlin Wall and the new prominence of international terrorism, the United States, Europe and Russia were all undergoing a great deal of adaptation and were largely preoccupied with internal issues of one kind or another. The Europeans were principally focused on the process of deepening the European Union; after a long-standing focus on the Cold War, the United States refocused inward. The 1990s were a tumultuous decade for Russia, with many false starts, many promises, and much potential.

Since September 11, I think we have seen some truly striking changes, and I am generally optimistic about the shifts occurring after that event. The transition in Russian policy in particular is really quite stunning; it seems to me that Vladimir Putin took advantage of the opportunities created by the terrorist attacks to accelerate the process of moving Russia into the western camp, to opt for a western approach towards the development of Russian institutions, and to move closer to the Bush administration and to some of the major European powers. In some ways, this may represent a kind of existential decision to westernize. Although it is unclear to what degree other elements of the Russian elite accept this trend, it nevertheless signals a real opportunity for Russia to become a true partner of the West, particularly in view of the very impressive strides towards economic reform it has made.

There have been equally startling changes in European attitudes. For the last ten to fifteen years, a major preoccupation of U.S. policymakers was convincing Europeans to engage in out-of-area activities. In a matter of twenty-four hours, the Europeans lost their aversion to military involvement outside their continent. Now the question is, to what degree this is a unique development and to what degree it will be sustained? Regardless, the political decision of major European leaders to join forces with the United States and create a coalition to fight terrorism, is a stunning development. I think it has also proven to be immensely popular domestically in Europe. The German chancellor may well have taken a strong forward position on this because he understood the German public's support for what he called a policy of "unlimited solidarity with the United States," a phrase I find to be very striking political language.

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September 11, naturally, had a deep impact in the United States, for obvious reasons. It awakened both U.S. public opinion, and the American foreign policy establishment, from a sort of post-Cold war parochialism. It has also created what even the Cold War did not — public support for very engaged American policy abroad.

There are a few very important issues that I think require examination. The first is: to what degree does NATO fit in this new consensus in the United States for a more active, engaged foreign policy focused on fighting terrorism? Some Americans have suggested that working with the United States in this new policy of engagement is easier than the Europeans perceive it to be. However, the proponents of such views are Atlanticists, and as such would naturally like to have European involvement in projects with the United States. There are other Americans who are skeptical about what the Europeans can contribute, and would rather not have them involved in any way in setting the agenda. This faction is largely responsible for the increased level of attention being drawn to the issue of the growing capabilities gap between the United States and Europe, and for the questions being raised regarding the degree to which the Europeans can make a difference militarily as well as politically. And, to be quite blunt, many of these Euroskeptics are in the policy-making ascendancy at the current time. So this debate within the United States about Europe will have, I think, an important impact on the degree to which American policy is open to working and consulting with the Europeans.

A second question is: will trilateral cooperation be effective? I believe that the United States can find ways for involving both the Europeans and Russians on a range of issues. The stage has already been set for such trilateral cooperation in southeastern Europe. I see no reason we should not be able to sustain and extend the successes we have had in the Balkans in other areas, for example in resolving the dispute between Turkey and Greece over Cyprus. This seems to me to be an issue that for a variety of reasons, particularly given the prospect of EU enlargement in that region, is especially ripe for progress. This is an excellent example of a situation in which Europe and the United States together could make a difference. Central Asia is also a region in which a trilateral partnership and cooperation could be very beneficial, and where there is already a precedent for such collaboration set with the war in Afghanistan. Russia will of course continue to play a prominent role in the region, but there is an opportunity for the United States and to some extent Europe to be involved in creating stability. In Southwest Asia, nuclear rivalry between India and Pakistan and ongoing conflict in Kashmir present another opportunity for Europe, Russia, and the United States to concert policies to make progress.

There are two issues, however, that I have not mentioned as candidates for cooperation because they are so critical to the actual development of the relationship, rather than simply as its outlet. Whether or not we will work together in the above areas will depend in large part on what we do in Iran and Iraq. With regards to Iraq, it is my judgment there is now a consensus in Washington to undertake a program seeking regime change in Baghdad. The political prelude will clearly involve some form of inspection proposal made to Iraq, the response that Iraq makes to that proposal, and the way in which the United States, the Europeans and the United Nations respond. Whatever the modality, it is very clear that we are coming to a showdown within the next six months or so. The only point I would like to make on the situation with Iraq is that the issue of weapons of mass destruction has to some degree been merged with the issue of terrorism in the minds of many Americans. And while it is important in some cases to separate the two issues, in the case of Iraq, I think that is going to be difficult. This will be a critical area

for consultation and discussion, but in the end it will be very hard to move the United States away from the position that the time has come to confront Saddam Hussein.

The second area, Iran, is an area in which the Europeans can have a much greater influence on American foreign policy. Obviously, the Iranian case is far more complex than the 'axis of evil' language used by the U.S. administration implies. This is an area in which the Europeans have an economic stake, the Russians have an economic stake as well as a nuclear relationship, and the United States has very important security interests. Given these substantial ties, Iran may well be a much better candidate for trilateral agreement than Iraq, and cooperation on this issue may go some way towards healing ruptures caused by any future disagreements over the U.S. goal of regime change in Iraq.





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# The Window of Opportunity in Russian-Western Relations

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By Sergey Rogov<sup>45</sup>

The terrorist attacks on the United States on September 11, 2001, reshaped history, causing some things to change irreversibly. For America, this is an event comparable to Pearl Harbor, or perhaps even more serious since this is the first time since the Civil War that war has been fought on U.S. soil, and with the highest number of U.S. civilian casualties in any conflict. September 11 will have enormous implications globally as well.

The attacks have challenged many of the premises of international politics. It is too early to draw the final conclusions, but it is possible to provide a preliminary analysis of the far-reaching consequences of these events for Russian-western relations.

After the end of the Cold War, it was suggested that the Russian-U.S. relationship should be built on the basis of mutually assured security rather than mutually assured destruction. But the “strategic partnership” which Clinton and Yeltsin proclaimed failed because parallel interests were not sufficiently strong — there was no common enemy.

But the terrorist attacks of September 11 have provided a vision of the new strategic framework: to fight international terrorism as a common enemy. Historically, when Russia and the United States have faced a common enemy, they have cooperated as allies. That happened during the American war of independence, the Civil War, and the First and the Second World Wars, despite enormous political and economic differences between Russia and the United States.

Before September 11, Russia and the West were engaged in heated disputes about ballistic missile defense, NATO enlargement, economic problems and other issues. Will Russia and the West decide that the clear and present threat of international terrorism is the top priority, requiring a new alliance which will last well into the 21<sup>st</sup> century?

That does not mean that all previous problems will cease to be points of debate. It is impossible to resolve them all overnight. But an alliance does not require the participant countries to agree on

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everything. Let us remember that enormous disagreements between Roosevelt's America and Stalin's Soviet Union did not prevent them from successfully defeating Hitler. And even today there are some serious conflicts between the United States and European Union, the United States and Japan, and the United States and Israel. Nevertheless, these alliances work because there is an overwhelming common interest and all other problems are subordinated to that common interest.

Russia remains in transition, and while it increasingly shares many values with western democracies, Russian democratization is far from complete. Russian analysts have suggested that increasing economic interdependence will help deepen partnership and democratization, but Russia and the United States will retain differing views on some issues, just as the United States sometimes disagrees with its NATO allies.

An alliance with the United States and the European Union will tremendously help the integration of Russia into the global market, and into the western community. It also will give a boost to domestic political and economic reforms. Today the differences between the political and economic systems of Russia and western countries are smaller than ever, and both sides agree that they want to destroy Al-Qaeda and other terrorist regimes. But can this consensus translate into an alliance? Can Russia and the West overcome the legacy of a half-century of confrontation left by the Cold War?

It is time to think beyond mutual assured security and toward a strategic alliance between the West and Russia for the 21<sup>st</sup> century. An alliance means having a common enemy, joint decision-making, and joint actions. Obviously, other alliances might be more important. The Cold War legacy is still institutionalized, but it can be overcome. Both sides need to recognize the overwhelming higher interests they share. In the present conditions, we can and should agree that the common interests of Russia, the United States and the European Union should become the foundation of a new strategic framework.

Russian integration into Europe is an important goal, even if NATO membership is not. The key issue is Russia's relationship *with* NATO, not Russia's role *in* NATO; Russian membership in the alliance is not on the agenda for the foreseeable future. But Russia-NATO cooperation requires a closer partnership than has been evidenced previously, with deeper and more comprehensive consultations on key issues. This should evolve into a kind of "associate" membership, in which Russia is increasingly involved in more and more NATO decisions and actions, short of an Article 5 commitment.

The recent events have created a window of opportunity to build a new relationship. There are two major security areas where Russia, the United States, and the European Union can closely cooperate on the basis of common interests.

### **The Fight Against Terrorism**

The common enemy of Russia and the West is the new terrorism, which is closely linked to the process of globalization. Terrorism itself is centuries old, but the type of terrorism that produced September 11 is new. The old terrorism reflected political and social developments within a country and tended to have a political ideology, while the new terrorism has evolved to become a global force, which operates beyond borders.

Terrorism existed on the fringes of the Cold War confrontation. Both sides had their “freedom fighters.” The terrorist networks operated by both sides during the Cold War had a lot of autonomy even then, usually acting on their own. When the Cold War ended so abruptly, no one was prepared. These armies of freedom fighters were left to their own devices; some went home and became investment bankers, while others did not.

The current terrorism is qualitatively different. Terrorist groups now operate as global institutions (similar to other supranational institutions, like the IMF, or crime cartels). They rely upon networking and on global financial systems for their activities; this type of cross-border networking simply did not exist ten years ago.

There is a growing divide between the winners and the losers of globalization. Some societies have felt victimized by their inability to profit from globalization. The ideology of these new terrorists is based not on communism or anticommunism, but on nationalism and religious fundamentalism. The root of it is not in the Cold War confrontation, but has a life of its own. The reaction of Islamic fundamentalists to the challenge of globalization is not dissimilar to the reaction of those American radicals who carried out the Oklahoma City bombing – they had a connection to Christian fundamentalism. But Christianity had its crisis during the period of the Crusades and the religious wars of the 17<sup>th</sup> century in Europe — Islam is a younger world religion, which is having its crisis now, when the traditional Islamic societies cannot cope with the challenge of globalization.

Traditional terrorists always knew there was a risk of death that went with their actions, but they never planned to die. For new terrorists, suicide bombing is a commonplace method. While the Bolsheviks wanted to create paradise on earth, new terrorists are seeking a short cut to the paradise in Heaven. They cannot be deterred by the rational threat of “unacceptable damage.” To stop people like this, we need to invent a new way of fighting terrorism. Clearly, the mere threat of death will have little effect on those willing to carry out suicide attacks.

September 11 was the result of very professional planning by al-Qaeda terrorists. There is no comparable example — neither the bombing of the Marine barracks in Beirut or the attack on the World Trade Center in 1993 showed evidence of the same quality of planning, involving many small details and intricate coordination.

The terrorist attacks of September 11 may be perceived as the final end of American isolationism (of which national missile defense was a part); Americans now know that they cannot retreat to their fortress. Despite vast spending on defense, the United States has no way to protect its territory and population against this kind of attack. The concept of homeland defense is well known by Russians, who have often fought wars on their own territory. The United States in the 1970s thought the Soviets were ready to go to nuclear war because they had civil defense (of course, our word for civil defense was *grob*, or coffin). But how far will the United States take its current focus on homeland defense? Will the National Guard be reoriented to defend U.S. buildings?

Now there is an overwhelming priority task — to eliminate global terrorism. Russia has joined the international coalition organized by the United States. No one knows how long this war will last or what victory will look like. Will the fight against terror be the new core of American foreign and security

policy, the way the fight with the Soviet Union used to be? Will the new enemy be a relatively long-term focus, or just temporary?

Meanwhile, we see a formerly unilateralist U.S. administration creating a new global multinational coalition. But this is a new type of coalition, different from NATO or the Desert Storm coalition. It does not require consensus, being built on the “follow me” principle, with a sheriff deputizing whoever is willing to act. By announcing that the next target is “the axis of evil,” the Bush administration demonstrated that it is still willing to act unilaterally.

Russia reacted to September 11 terrorist attacks after some delay. The Russian public was confused, and the bureaucracy acted like it was business as usual, stating that this was an internal U.S. problem and that Russia has nothing to do with it. The situation changed on September 24, when Putin made the crucial decision to support the Bush administration. He had previously always tried to keep his options open and relied on bureaucratic consensus. In this case, his choice did not reflect what either the majority of the public or the bureaucracy thought. This was his first demonstration of real leadership — pulling society and the bureaucracy in a particular direction. Putin recognized that Russia and America now face a common enemy — international terrorism. And it is clear that bin Laden and the Taliban are enemies of both Russia and the United States. Remarkably, Russia provided the United States with unprecedented help — from support in the UN Security Council to access to former Soviet military facilities in Central Asia. This was greater assistance than what many NATO allies were able to give. There is even potential for joint U.S.-Russian war-fighting, although Russia will not go back into Afghanistan nor conduct anti-terrorist operations outside its own territory. There is neither the desire nor the means for such operations.

Russia wants some control over U.S. military actions in Central Asia, including assurances that the bases will not be used to attack Iran or Iraq. The question remains whether the United States will stay or leave after the war is over. It is not clear which Russia would prefer, but these are the sorts of issues that exist within any alliance.

However, Russians don’t see the threats from Iran and Iraq that are taken for granted in the United States. Russian economic interests in that region are a factor in this attitude. Putin’s authority would be needed to make a policy change on this issue, but everybody should understand that Saddam Hussein and Ayatollah Khomeini have no friends in Russia.

## **Nonproliferation of Weapons of Mass Destruction**

A common Russian-western agenda should go beyond terrorism and include a new reformulated non- and counter-proliferation strategy, which is required for the management of geopolitical change. This issue is much broader than the usual concern about “loose nukes.” While the challenge of terrorist access to weapons of mass destruction (WMD) is formidable, there are many problems related to the expansion of the nuclear club and the growing role of Asian nuclear powers, which are engaged in a very complicated and competitive relationship.

There have also been policy changes on South Asia. Economic and political concessions were made to gain the support of Pakistan in the war against terrorism. Pakistan and India have had their nuclear status de facto recognized, yet have not made any commitments “to play by the rules.” Thus, in order to get Osama bin Laden, the United States has abandoned its focus on non-proliferation.

There are reasons to be concerned with the possible development of weapons of mass destruction by Iraq, Iran, and North Korea. While Russia is not supplying these countries with prohibited technologies, Moscow should not ignore appeals to apply more pressure on possible violators to ensure they do not get access to WMD and the means of delivery. But the United States could commit a huge blunder if it decides to use force unilaterally against what George W. Bush defined as “the axis of evil.” Doing so may destroy the antiterrorist coalition when not only Russia and China, but also the European Union and many others, begin to object to the United States acting as a self-appointed world policeman.

What is required is better coordination of policy to prevent access to WMD. Better results could be attained by replacing some Russian trade deals with an arrangement providing domestic orders for Minatom to replace old type nuclear reactors in Russia and other former Soviet republics with safer technologies. That could be allowed if the Biden-Lugar legislation, which calls for restructuring of the Russian foreign debt if Moscow agrees to spend the money on elimination of nuclear and chemical weapons, etc., is implemented. The Biden-Lugar approach could be effective if it is supported not only by the Bush administration, but also by the EU, since the member states own most of the Russian foreign debt. The international community can do more to help those who want to reduce or eliminate weapons of mass destruction, but more money is needed to do the job. This may apply not only to Russia but to some other countries as well.

The consequences of the legitimization of nuclear weapons in India and Pakistan are profound. They are engaged in a protracted Cold War, which is regularly interrupted by “hot” wars. At present they are on the verge of another open confrontation, which could easily escalate into a nuclear exchange.

China remains a problem for Russia, which until recently had a troubled relationship with the West, was threatened on its soft southern underbelly, and did not want to deal with an unpredictable eastern neighbor. In recent years, Russia has sought to accommodate China by giving in to their shopping lists of modern conventional weapons. If the West really becomes an ally, then Russia no longer needs to “appease” China and should refrain from meeting Chinese requests to sell strategic technologies. Neither U.S. nor Russian unilateral dealings with China have been very successful. But the U.S.-Russian alliance should not be aimed against China. We can help China make the right choices, although the situation could be complicated by unilateral U.S. deployment of ballistic missile defenses.

Is it now possible for Russia and the United States to find compromises on the issues that previously divided us, such as ballistic missile defense (BMD), NATO enlargement, and the arms trade with Iran and China? After all, missile defense is still the least efficient means to fight against terrorism. The terrorists were able to use primitive means to inflict WMD-size destruction on September 11. The Bush administration decision on December 13 to withdraw unilaterally from the Anti-Ballistic Missile (ABM) treaty severely damaged the existing arms control regime. But at the same time, is BMD really a threat to Russia? Russia’s retaliatory capabilities will not be seriously damaged when the United States deploys limited defenses (and they will remain limited for many years).

But China may interpret American BMD capabilities as a denial of the Chinese nuclear posture. The BMD factor, together with nuclear build-up by India, may result in the Chinese decision to speed up and expand modernization of the Chinese nuclear forces. Within a decade their nuclear arsenal can grow to 1000 warheads. They can also try to acquire counterforce capabilities towards India (and part of Russia as well).

It is necessary to develop new approaches to arms control, preserving the basics of Russian-American arms control and inducing other major players to accept at least some of the rules of the game. The Bush-Putin summit in May 2002 saw the signing of a new legally binding agreement on strategic weapons, establishing a common ceiling without prescribing the force structure of Russia and the United States. Below the ceiling (between 1500 and 2200 of operationally deployed weapons), each side will be free to choose which systems it wants to keep. The new arrangement will replace both START-1 and START-2 with their rigid prescriptions of force composition, while saving the verification regime for strategic weapons. The control and monitoring regime established by START-1 should be, on the one hand, simplified, but on the other hand, expanded. It is necessary to adopt some measures to verify transportation, storage, and elimination of nuclear weapons and nuclear materials.

The next step may be a Russian-American proposal to China and other nuclear powers to accept some transparency measures. While it is unrealistic to expect other nuclear powers to reduce their arsenals, transparency measures may be more acceptable to them. The comprehensive approach to nonproliferation should be aimed at establishing some form of accountability and safety for WMD, while providing financial and technical means for their elimination.

The environment within which Russia and the West now live has changed decisively since September 11, 2001. Among other things, the western community and Russia today share a common threat perceptions on many levels, and there are a number of areas in which they can work to foster cooperation. It is necessary to transform shared interests into effective common action, while meeting the other needs and interests of both sides.

Thus, Russian-western cooperation should be pursued in a framework that aims to create a sense of stability, confidence, predictability and transparency that can guide the NATO-Russia relationship. That will allow implementation of the principle of shared responsibility for joint decision-making on the basis of consensus, and launch a practical agenda of things to be done in both the European and global space. For these purposes, it is necessary to establish new mechanisms for discussing and resolving the inevitable differences between NATO and Russia, the EU and Russia, and among western states themselves, as well as for containing those differences when they cannot be resolved. These new institutions will focus on what the West and Russia can do together to respond to threats from elsewhere, and on what NATO, the EU, and Russia may do elsewhere to shape a more congenial future, and to strengthen international security and strategic stability by adapting the existing arms control regime to the new global reality.

# The Future of Russia-West Relations

## Moscow, July 2001 • Berlin, February 2002

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