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SESSION ON AUSTRIA

SUMMARY

The opening session of the 31st European regional meeting of the Trilateral Commission, held in Vienna, October 27th 2007 under the chairmanship of Peter Sutherland, was addressed by H.E. Dr Alfred GUSENBAUER, Federal Chancellor of the Republic of Austria, followed by Dr Martin BARTENSTEIN, Minister of Economy and Labour. Ursula PLASSNIK, Federal Minister for European and International Affairs of Austria also addressed the audience in the evening.

What is new in Europe? Schengen and Lisbon.

Schengen demonstrates physically that the walls have fallen, and that Europe is becoming one. People feel like being European whenever they cross a border without meeting a border. Austria is committed to manage the opening up of its borders with four neighbours from the former East in a way that makes Europe tangible to all.

The treaty signed in Lisbon is another major step forward. Indeed, it lifts blocages, rather than it pulls Europe further, as it is all about consolidating the legal basis we already operate from. The major outcome of the treaty is that Europe is now out of the pitfall the year 2005 had carved, when two negative referendums clogged the European process. Now the homework is done, and governments can come back to their constituencies with good European prospects, that can be made clear and positive to the public. The control of national Parliaments has been enhanced over an improved subsidiarity, going both ways, to, but also from, Brussels.

The unification of Europe is the task and duty of this generation. Austria is striving to achieve that purpose, and **extend it to the Balkans.** Under Austria's chairmanship, no effort was spared to restore Europe's commitment to drag the Balkans out of their mayhem, and welcome them as European fellow countries, soon to become full-fledged Members. The Balkans are now doing fairly well as a whole, and Austria lays a major emphasis on helping them to become European-styled, since keeping a grey zone in the neighbourhood, indeed the very middle of the EU, would not be of any good.

Kosovo remains the last and most thorny piece of the puzzle. It sets a major test for the European External and Security Policy, which actually only took off as an aftermath of the Kosovo war, some ten years ago. Kosovo has to be dealt with as a European matter, by Europeans, acting in close connection with their historical partner from the West, the USA, and their strategic partner from the East, Russia. This is in the making, thanks to the very skilled and talented team called the Troika. It will not be an easy issue to sort out, but Europe must remain united on this, as opposed to its split positions on Iraq earlier on, for example.

Austria strongly supports a united European attitude, and will help Slovenia to steer the EU along that line during its presidency, the first one by a new member from the former East, and indeed by the first of the class in every respect. On top of that, Austria is actively engaged in supporting women and youth in Kosovo and Serbia, as women are key to impacting attitudes. They mould a nation's behaviour. Experience from the Middle East is used to develop programs impacting women's vision of the world, which in turn changes overall references throughout the nation.

Young people in Serbia and Kosovo are granted a visa and a railway pass to travel across Europe and open up, while others are offered an internship in Austrian companies in their country. The basic idea behind all this is always the same : allow people to expose themselves to other experiences than what their backyard has to offer. This is what Europe has so successfully achieved, and this is what will end up making the Balkans European too.

Kosovo will be the touchstone for EU foreign policy : Austria expects the 25 countries to act as one with respect to the issue of independence there, **a case that needs pragmatism rather than clearcut options**. Actual freedom matters more than the name attached to it, as it were, at the moment. Participating in the global change is what makes the difference.

Austria supports further enlargements, to begin with Croatia. The country's banks and businesses are deeply engaged in Eastern and Southern Europe's recovery. **This is boosting Vienna as a major financial and economic centre**. The understanding of the linkage between internationalisation (near and long range), social integration, and development, is trickling down across the Austrian society, thanks to the stress laid on

enhancing social capital, quality of life, universality of human rights, as major tools for cutting-edge competitiveness.

Austria supports both enlargement and deepening integration. Yet, Austria's wealth makes it **a net contributor to the EU, hence a cautious negotiator** when it comes to welcoming new members that would make the bill heavier to top. And enhancing harmonisation to improve EU economic governance does not call for tax alignment first.

Austria welcomes European integration: the pace at which major achievements have been accomplished (European currency, 1999, further enlargement, 2004) proves that European commitment pays. The new treaty agreed upon in Lisbon will help a lot, and means a lot, as it makes the EU Charter of fundamental rights legally binding. Deeper integration and timely enlargements have made a world power of the EU. And this is particularly felt in **Austria, once a small country on the edge of the West, now a masterpiece at the centre of an expanding open Europe.**

This social and mental change is very much along one of the main benefits of the European movement, namely bringing about convergence between ideas and orientations previously different, towards key policy objectives.

Europe has lifted Austria into internationalisation, modernisation, and change. The successful involvement of the country in Europe's integration and enlargement has pulled employment upstream, and Austria is currently **experiencing a shortage of high skilled manpower.** This is driving Austria's policy in the field of education (promote qualification), of immigration (welcome upmarket applicants, train and integrate lower level ones, delay further inflows of non-qualified immigrants and therefore **refrain from integrating Turkey upfront**), of labour (bring the retirement rate down). Demography is a key factor, both quantitatively and qualitatively.

Austria is the now the third best place in the world as far as happiness can be recorded, **and the first one in Europe for the quality of life**, a top one for GDP per capita (higher than in Germany), the rate of employment (down to 4.2 % unemployed, on the fringe of the 3.9 % incompressible ratio benchmarked by the OECD), rate of economic integration

(imports and exports both to and from EU over a third of the GDP), rate of cross-investments with the EU (above 15% of GDP both sides).

Austria seems to benefit from having the optimum size, as other success stories within the EU suggest: effectiveness ratios among the EU 25 advocate that “**small is beautiful**»!

OPENING ADDRESS BY DR. ALFRED GUSENBAUER

FEDERAL CHANCELLOR OF THE AUSTRIAN REPUBLIC

I am delighted to address this audience of distinguished policy makers, experts and business leaders and I am particularly pleased to share my views on emerging issues related to Austria but also to European integration. Part of my talk will focus on the particular significance of this integration process for us here in Austria.

A week ago, a final agreement on the new Reform Treaty has been reached in Lisbon. This treaty clearly represents a major achievement. Without this Reform Treaty, the stalemate within the European Union would have continued. This treaty is the working foundation of an enlarged European Union and it also gives us the tools to address the great political challenges of the 21st Century.

It simplifies the decision-making process, clarifies the rules, and it strengthens the European foreign policy. It sets the foundation to better coordinate policies and instruments in the pursuit of common objectives. The new treaty brings greater efficiency and more democracy. In future, national Parliaments will be given a greater say in European Union policies. Most importantly, the treaty will make the European Union's charter of fundamental rights legally binding on European legislation. A brief historical perspective also helps us to appreciate the achievements of this Union. Twenty years ago, only a small number of observers predicted or projected monetary union starting already in 1999. Hardly anybody who wanted to be taken seriously in the political world or in academic foresaw an enlargement round already in 2004.

The fundamental geopolitical transformation of Europe opened the way for peaceful regime change and political and economic integration of former adversaries was no doubt one of the greatest achievements of the European Union. The integration of former communist countries was only possible due to the readiness and determination of the leaders of these countries to undertake often painful reforms. The benefits of European Union-membership are not equally distributed in our societies. And it will be one of the major challenges of the coming decades to help the greatest number of our citizens to partake in the economic success of our European endeavour.

The deepening of the European Union economic and political integration and the parallel pursuit of successive waves of enlargement have effectively made Europe a world power. Austria is a beneficiary of the European integration process in general and the opening up of eastern borders in particular. Geographically Austria is located in the very heart of the continent, but since Second World War it had been on the fringes of the free world. When the Velvet Revolutions of 1989 brought down the Iron Curtain, it also reshaped Europe's political geography. From our domestic perspective, the opening of our eastern borders has reintegrated Austria in a region, to which for centuries close economic, political and cultural ties had existed.

Economically, Austria is firmly anchored in Europe. Active Foreign Direct Investments stocks in the European Union-25 amount to 15 % of its GDP, inward investment from the EU-25 is even slightly higher. Exports to the European Union have surpassed 40 % of GDP. Within this setting, relations to currently Europe's most dynamic region, to Eastern and Central Europe as well as to Southeast Europe are the strongest of all OECD countries.

Particularly Austrian banks seized the opportunity of the emerging markets in Central Europe. Using “first mover advantage” Austrian banks now have a significant market share not only in the new Member States, but also in current and potential candidate countries. The intense engagement of the Austrian financial sector in the region, in Central and Eastern Europe, as well as growing earnings of Austrian companies doing business in Central and Eastern European countries has had a side-effect: Vienna has successively developed as a regional financial centre. The Viennese stock exchange started to become an important competence cluster for Eastern European projects. “Centrope” has been established as a cross-border initiative in order to draw international investors to the region surrounding Vienna, including neighboring areas in the Czech Republic, Slovakia and Hungary. Further strengthening of Vienna’s role as a financial center and its role as a gateway to the new EU Member States will be beneficial for the entire region.

Both, EU membership and enlargement have enormously accelerated Austria’s economic internationalisation. Our GDP per capita is now one of the highest in the European Union, whereas a few decades ago our biggest exports were highly trained workers to Germany. The macro economic performance is generally sound with above average growth, with one of the lowest unemployment rates in the European Union, low inflation and declining budget deficits.

But this is only one side of the coin. The flip-side is stronger exposure of small and highly globalized economies to external economic disturbances. Furthermore, many Austrians feel they have not, or at least not sufficiently, participated in general welfare gains stemming from European integration. Bearing this in mind, the Austrian government has set a quite ambitious agenda for economic reform, which forms a coherent strategy of measures that reinforce each other with respect to economic growth, employment and fair distribution. For our growth strategy, we looked to Scandinavia in practice and not at Chicago theory. We decided to invest more heavily in social capital. Unlike critics of the welfare state, we believe, and have the proof, that a developed social system does not diminish the competitiveness of a country as long as it supports employability, operates high technological standards, and has a high-quality institutional framework for entrepreneurial activity.

Enhancing growth through innovation is another top priority: over the past fifteen years Austria has continuously improved its technological position and increasingly becomes a top-notch location for research. One of our many endeavours here is to foster technology that helps to decouple energy consumption from economic growth. However, Austria still must evolve out of the low to the medium technology range in order to become a provider of high technology. This is why our research and innovation structures have to be strengthened for competing in this first league.

Education, starting at pre-school, is a key factor for sustained growth and competitiveness. Education is also the key for a fair and just society that offers opportunities to all. Education reform is therefore a crucial element of the science innovation and education triangle and one of our pressing endeavours for the future. We must not get stucked in the ideological battles of the past but see what works best in the interest of our children. International best practice, not home grown dogmas should inform this debate.

We are all proud that an Austrian could get elected as Governor of California. But would a similar situation be possible in an Austrian Bundesland? Given that more than 12 % of the country’s inhabitants are not Austrian born, the comparison is not as far-fetched as it

might look at first sight. Integration policy has become an integral part of our growth strategy. Language acquisition, early childhood education as well as participation in civil society are corner stones of this program. Only education will provide immigrants with the opportunities they seek when coming to our countries. Like in most of the other OECD countries, labour market integration is an issue of particular concern. More and more, the specific situation of second generation immigrants deserves attention, meaning educational and social investments. So far, our success is everything but promising.

Ladies and gentlemen, just to get back to the beginning of my talk, to my assessment of the Reform Treaty. Another substantial achievement of European integration, widely neglected, is the continuous convergence of previously different ideas and orientations towards key policy objectives. We have seen the promotion of deliberative problem-solving in various dialogues, committees, expert meetings and Council formations. This is particularly true for economic policies, to cite for instance the Lisbon agenda, where intergovernmentalism prevails successfully, while at the same time, fostering further integration and efficient problem solving.

This convergence process of ideas was upheld despite of the loss of confidence following the rejection of the Constitution two years ago. The down-side is that the convergence of ideas is largely restricted to the representatives of the states and experts. The technocratic elite, as it is often labeled, has at the same time probably become more distant from the public, more distant from the instruments that has traditionally insured democratic accountability at the domestic level. With the renewed Lisbon agenda we have found the correct way to increase democratic legitimacy, by involving the civil society, the Parliament, the social partners, into the design of the national reform programs, our national employment and growth strategies. This kind of deliberation has superseded a more technocratic approach which was less accepted by the public.

One major impact of this more inclusive form of economic governance, also supported by academic research, is the evolving compromise around the European Social Model. Equity and efficiency are no longer considered as mutually exclusive policy objectives. This represents a major change to the discourse five years ago. Solidarity, cohesion, a high degree of income and wealth quality, equal opportunities and the fight against all forms of discrimination are increasingly seen as major prerequisites for economic success and high productivity, to reap the full potential of an innovative knowledge-based economy. Flexicurity is a case in point which is now seen more as a policy for adaptability and social security rather than for pure flexibility and deregulation of the labour market. The latter is of course a major prerequisite for adjustment to rapid technological change and globalization. Flexisecurity is the right answer to the wide spread fear of rapid change and social exclusion in many parts of Europe. We cannot blame people who consider themselves losers of European integration for not appreciating the Union. There is no alternative to enhancing inclusivity, diversity, quality of life and universal human rights. And these are exactly the targets and the aims of the present Austrian Government and you will hear some more evidence of the result of our endeavours when our Minister of Economy will address you later on.

Thank you for your attention. I wish you a successful conference, and a pleasant stay in Vienna.

SESSION on A RESURGENT RUSSIA AND EUROPE

“ENGAGING WITH RUSSIA: NEXT STEPS”

(Updating the 2006 Trilateral Task Force Report)

SUMMARY

Russia is back. The former Soviet Union is not.

The USSR used to be a mighty challenger to the West, and was dealt with as a very scary power. But at the end of the day, the West could manage to trim that enemy down, and to win the Cold War.

Then came a time when everyone was frightened by Russia’s weakness and possible collapse, as the falling apart of the former Soviet empire opened the Pandora box of multiple dangers worldwide, ranging from the proliferation of all kinds of traffics, including weapons up to nuclear disposals, to the unpredictable consequences of despair, misery and weird governance on a large array of people across the continent. But the most dangerous side of traffics and proliferation could be monitored and even contained; governance was restored in different ways, ranging from authentic democracy to genuine tyrannies (indeed most of the time a very strange blend of both); economic reorganisation ended up soothing the people’s worst deceptions with the evidence of on-going development.

Now the situation has shifted again, from the gloomy prospect of Russia’s weakness turning into a nightmare, to the scaring shadow cast by Russia’s aggressive come back on the international scene as a nasty player.

The ruling group in the Kremlin is deeply entrenched in power, and quite decided to remain in charge. How Mr Putin will manage to achieve that purpose, despite the constitutional rules, is not yet quite clear, but he is making sure that his leadership will not be overruled. In doing so, he is relying on the very carefully designed grid of power he has put in place, nominating his people at all decisive positions. He does treat opposition brutally, he makes every effort to steer the country’s public opinion, and, in dealing with foreign affairs, he has never forgotten the lessons learnt where he first belonged, the KGB. But he enjoys a

sweeping popularity, and is smart enough to act in a way that flatters Russian pride. Two out of three citizens would like him to remain in power for life!

Western democracies consider that new deal with awe and sorrow. They are disappointed to see Russia neglecting one of their major concerns, namely their claim and care for human rights, and coming back to them harnessed with the harsh side of both wild and monopolistic brutal capitalisms, as a newly over-westernised country, but a plainly anti-Western one by the same token, as far as playing by the Western rules is concerned.

The West is getting anxious again, and considers with growing uneasiness the blunt outcome of a modernisation it has itself triggered and backed in Russia: an unfriendly, non democratic, awfully Russian Russia is unfolding its own understanding of what a brave new world should be.

How could this happen, and what can we do about it?

The first fact to bear in mind is that two West's instead of one now surrounds Russia: Asia is the new West.

Any move from the West can make Russians nervous, because they begin to see themselves as a besieged nation. And, inasmuch as economic conditions are recently giving them a series of new leverages on the West, they are naturally prone to make use of such tools either to retaliate, or for the mere sake of alleviating the pressure they feel upon themselves. Why should their big country keep abiding by the rules enforced on it, when the rulers are undergoing difficult times themselves, and begin to need Russia's support? The Europeans may well keep a high posh profile of democracy preachers, but they need energy, and are loosing control over its sources; the Americans may well cherish the idea that they are the only hyperpower in the world, but they can neither get rid of the Iraqi mayhem, nor keep the two other "rogue states" under control, nor make peace in the Middle East, nor even solve the question of Kosovo, in a time when Russia is no more the cause behind any of these issues.

Everyone needs Russian help. And this has a price. A much higher price now than when that support was offered by a still ailing Russia, and was rebuked. Now, Russian

leadership is decided to play that card the tough way round. By doing so, they are playing realpolitik.

Indeed, the West has failed to design and unravel a fair vision of Russia's role in Europe and the World. It made the most of Communism's fall down, without considering Russia's own interests seriously. If this was a revolution, now is the time of the inevitable restoration.

As the balance of power is now changing to the benefit of Russia, their leaders fire back and pull rank. They know that such structural shifts **owe much more to the global arena than to Russia's own achievements**, and they **do not mean to defy the West**. However, the focus laid upon Iran by the American administration, and the want of Western Europe for Russian energy supply, gives them **a fairly good hand to play**. And Putin is a smart player.

If the threat of an Iranian bomb, soon to be followed by a proliferating Arab world, is the priority to address, then **the West has to deal with Russia**, and forget about preaching that country the Western rules. Russia is never to become the former USSR again. Freedom is blossoming there, even if democracy is not. The Russian people are eager of enjoying pride again about their country, and they are grateful to Putin for having presided over this. They have horrible memories from the communist past, but not very good memories from the post communist period either. They need time, and a new generation taking over, to unravel their own path to democracy and welfare, which will not be from the very first day the perfect model that we are still fine-tuning after centuries of democratic life and economic progress.

While this has still to be invented, they are aware that **they are enjoying a peak time on the global scene**, and that they ought to take advantage of that phase to reinflate the balloon of their sovereignty and power as much as it can be reinflated.

There was a time when they had to sign up to every move the West was enforcing on them ; then came another time when they would have been grateful for the West to engage in some great deal about energy-for-investments, technology and friendship, but the West did not bite the hook; now such times are over, and the Russians understand that they can force

the West to take their own concerns into consideration, and to accept them as world players again in the first place.

This shift of power is recorded as a profound deterioration in East / West relationships, as the Russians do not refrain any more from worsening any difficulty met by the West, if only to raise the biddings much higher.

Since the US (very well tuned to Israel in that respect) are considering the Iranian bomb as the main threat for the world, and Europe is at loss with Kosovo, while the global picture of current geopolitics are deteriorating for the West, it might be wise to care about Russia, irrespective of whether we are fully happy with the level of democracy over there or not.

We have a vested interest in dealing with a power, which controls so much, directly or indirectly, of Europe's energy fuelling, and which ever proved to be a reliable supplier. We do not need Russia to indulge in choosing the West enemy's side, which could be a strong temptation for her, as she would gain influence, power and wealth from any scenario putting the West and the Muslim world at odds, for example. We would be stupid to push Russia and China into clustering against the West, as they have not much in common, but failing to offer better opportunities is tantamount to making headway in that direction.

We should understand that the Russians are not ready to embrace our postmodern vision of democracy, human rights, balance of power, rule of law, and the like. They are undergoing an experience of their own, coming back from a very deep and dark past, absorbing the shock of a collapse and of the ensuing western invasion, and they feel a very powerful need for carving their own way again.

The new Russia standing in front of us is not the most pleasant one the West would have wished. But is unfortunate that, while a huge majority of that Russia's trade and interests are with the West, it did become rewarding for its leaders to spur a fairly anti-Western attitude. Russia is and will remain a major partner. Taking her on board will have a growing price; trying to keep her out will have a much higher price.

There is way for mutual understanding, and, if this is still too much, there is room for refraining from making things worse. Economic forecasters suggest that the hard rules of economy will bring about a need for a major brush-up of Russia's economic patterns, which will iron out the present extraordinary situation, and even up Russia's economy with mainstream world economy. It is therefore understandable that their leaders try to harvest as many benefits as they can from the current, transitory and unexpected, state of affairs. They have a window of opportunity to catch up on the West, and they manage to take advantage of it.

The West should not necessarily consider that move as a hostile one, and should probably refrain from displaying unfriendly attitudes. Stretching NATO further, in particular to Ukraine, would be a mistake.

It is true that the relationship is deteriorating between the West and Russia, but we should consider the future, and understand that **interests are converging in the not so long run**. We missed the grand deal on energy, but many commercial links are weaving a web of invisible mutual dependence; Iran is a partner to Russia, but Iran going nuclear might threaten Russia too; China has no reason to join Russia in any anti-Western alliance, and Russia has no reason to build upon the Islamist anti-Western movement.

Russia is managing Russia's interests, not challenging the West. Those interests are not as streamlined with the western vision of what should be than many in the West would wish, but they are what they are, a serious part of the game we have to play, and we have not other choice than to take them into account.

The question is about the price to pay for engaging Russia into a fair partnership on what matters most, and reaching better times without having turned an ailing relationship into a bad one. Putin will bid the price as high as can be, with support both from the establishment and the people. If we want him to consider other strategies than putting Russia's position as high as he can, we'd better find good arguments to convince his people and himself, and display genuine consideration for a fair partnership, rather than stick to what they resent as a proxy to disregard.

The West has to decide what it takes to help Russia move the right way round, all by herself, at her pace, towards another smooth revolution, made of the economic and perhaps political reforms, direly needed if the present wealth is expected to be turned into sustainable welfare and development to the benefit of the Russian people themselves.

Unless the West considers dealing with Russia, Russia is very likely to move the wrong way round and to make international life more difficult, let alone Russian democracy. The Russian leadership is doomed to cash-in either large winnings or very large winnings, depending on the West's options, but there are no more options, for the time being, in which the West ever wins.

BACKGROUND UPDATED PAPER BY SIR RODERIC LYNE
European Author of the 2006 Trilateral Commission report on
“ENGAGING WITH RUSSIA: THE NEXT PHASE”

SELECTED POLITICAL STATEMENTS AND MEDIA COMMENTS, 2007:

FROM THE WEST:

Letter in The Economist, September 8th, 2007 from William Manthorpe, Rehoboth Beach, Delaware :

“SIR – Upon my retirement in 1994 as deputy director of naval intelligence, and the American navy’s remaining Sovietologist, the chief of naval operations asked me: “What will become of Russia?” I answered that I did not know exactly, but I was sure that in about ten years it would again be an authoritarian state. Not a hard prediction of course. Any scholar of Russia knows that Russian history revolves around long periods of authoritarian rule, broken only by brief periods of chaotic liberalisation before a new kind of authoritarian regime comes to power to exploit the nationalistic anti-Western xenophobia of the Russian people.”

Commentary by Stefan Wagstyl in the Financial Times, May 28, 2007:

Headline: “Murder and oppression will not earn Russia respect”

“Claims that Vladimir Putin, the Russian President, is criminally responsible for Mr Litvinenko’s death are rightly condemned by the Kremlin as absurd. No evidence has emerged to support such allegations. But the Russian leader is morally responsible for presiding over a country in which murder has become a tool in politics and business....The Kremlin must learn that respect comes not from bullying neighbours, still less from oppressing their own citizens. If Russia’s leaders really want it to be seen as a “civilised” country they must embrace “civilised” standards, including standards of human rights.”

Senator John McCain, in the Financial Times, June 13, 2007: *“In perhaps the most direct challenge by any nation to Euro-Atlantic security since the end of the cold war, President Vladimir Putin has threatened to target European capitals with nuclear weapons and veto a United Nations resolution on the status of Kosovo....A profoundly authoritarian regime, dominated by an intelligence service hostile to western liberal values and flush with cash from oil and gas, holds power in Moscow. This development calls for a new Western approach to a revanchist Russia, grounded in our shared strength as liberal democracies.”*

Editorial in the Financial Times, June 13, 2007:

“In Russia today, the rule of law remains erratic, the courts are corrupt, and property ownership can seldom be guaranteed.....Anyone doing business there would do well to remember the words of Vladimir Ilyich Lenin: “ A capitalist is someone who sells you the rope with which you hang him.” They have not been entirely forgotten in Russia.”

Headline in The Times, July 5, 2007:

“Russian missile threat to Europe raises Cold war fear over US shield”

Commentary in The Daily Mail, July 13, 2007, by Edward Lucas (of The Economist, author of “The New Cold War And How To Win It”) headlined “We Must Be Tough With This Despot”:

“If the skull and crossbones were flying over the Kremlin, it could hardly be clearer: Russia under Vladimir Putin is a pirate state that unashamedly flaunts its contempt for the law.”

French President Nicolas Sarkozy, August 27, 2007:

“La Russie impose son retour sur la scène mondiale en jouant avec une certaine brutalité de ses atouts, notamment pétroliers et gaziers, alors que le monde, l’Europe en particulier, espèrent d’elle une contribution importante et positive au règlement des problèmes de notre temps que son statut retrouvé justifie.”

The Financial Times, October 3, 2007:

Headline: “Gazprom threat to cut Kiev gas”

News Analysis: “Yesterday the Russian state-controlled gas group gave a demonstration of its political clout. Its decision to threaten to cut supplies to Ukraine just as pro-western parties were poised to win power in Kiev struck observers outside Russia as clearly political....The move will do nothing to improve Gazprom’s hopes of securing wider access to the EU, as one of the main concerns of its EU-based critics is about political influence at Gazprom....’This statement is connected to the results of parliamentary elections and the upcoming change of government,’ said Valery Nesterov at Moscow brokerage Troika Dialog.

The Times, October 13, 2007:

Headline: “Putin confronts US with threat to arms pact”

“Vladimir Putin threatened to abandon a key nuclear arms treaty yesterday as he raised the stakes in the confrontation between Russia and the United States over a missile defence shield in Eastern Europe.....Mr Putin said that Russia would leave the INF treaty unless it was turned into a global agreement to constrain other states, including those ‘located in our near vicinity.’”

FROM RUSSIA:

Russian President Vladimir Putin

February 10, 2007 (43rd Wehrkunde Security Conference, Munich): *“Unilateral and frequently illegitimate actions have not resolved any problems. Moreover they have caused new human tragedies and created new centres of tension...Today we are*

witnessing an almost uncontained hyper use of force – military force – in international relations, force that is plunging the world into an abyss of permanent conflicts.....We are seeing greater and greater disdain for the basic principles of international law....The United States has overstepped its national borders in every way. This is visible in the economic, political, cultural and educational policies it imposes on other nations.... This is extremely dangerous....The force's dominance inevitably encourages a number of countries to acquire weapons of mass destruction....Star wars is no longer a fantasy – it is a reality....The militarisation of outer space could have unpredictable consequences for the international community and provoke nothing less than the beginning of a nuclear era....NATO expansion does not have any relation with the modernisation of the Alliance itself or with ensuring security in Europe. On the contrary it represents a serious provocation that reduces the level of mutual trust. And we have the right to ask: against whom is this expansion intended?..... Russia is a country with a history that spans more than a thousand years and has practically always used the privilege to carry out an independent foreign policy. We are not going to change this tradition today.”

April 26, 2007 (Annual Address to the Federal Assembly): “Some, making skilful use of pseudo-democratic rhetoric, would like to return us to the recent past, some in order to once again plunder the nation's resources with impunity and rob the people and the state, and others in order to deprive our country of its economic and political independence. There has been an increasing influx of money from abroad being used to intervene directly in our internal affairs....We recall the talk about the civilising role of colonial powers during the colonial era. Today “civilisation” has been replaced by democratisation, but the aim is the same – to ensure unilateral gains and one's own advantage and to pursue one's own interests.”

May 9, 2007 (62nd Anniversary of Victory in the Great Patriotic War): “Those who attempt today to belittle this invaluable experience and defile the monuments to the heroes of this war are insulting their own people and spreading enmity and new distrust between countries and peoples...These new threats, just as under the Third Reich, show the same contempt for human life and the same aspiration to establish an exclusive dictate over the world.”

September 10, 2007: “We have differing approaches [from the United States] regarding many issues on the international agenda.....The question is one of what means we use and in what spirit we resolve these problems. We can take a confrontational approach and rattle our sabres, try to scare each other, and we can look for compromises and come to agreements. Our hope is that we can take the second road.”

September 14, 2007: [To Western journalists in the Valdai group:] “We shall be glad if you can transmit your knowledge and understanding of Russia to your spectators and readers, in order to rid them of stereotypical notions that are still very strong... among people in the West.....

I see no instrument capable of stabilising the country other than democracy and a multiparty system.....

We very much want to work with an independent European Union that will defend its own interests above all through dialogue with us. I recommend thinking about sovereign democracy. It is a concept that could be of interest for the European Union

and for individual European countries.....There is a sort of transatlantic solidarity that comes across as somewhat foolish in my view.....Most people in Russia often see now that the position taken by European countries or the European Union is not sincere.....If the West wants to support 'orange' movements, let it pay for them. Or do you want to support them but have us pay the bill? Do you think we are idiots or something?"

"There are not so many countries today that have the good fortune to say that they are sovereign. You can count them on your fingers: China, India, Russia and a few other countries. All other countries are to a large extent dependent either on each other or on bloc leaders... Sovereignty is therefore something very precious today, something exclusive. Russia cannot exist without defending its sovereignty. Russia will either be independent and sovereign or will most likely not exist at all."

Russian Foreign Minister Sergei Lavrov (Article in 'Russia in Global Affairs', August 2007): *"The inertia of ideology-motivated unilateral responses has received its second wind nowadays. Hence "broken china" everywhere... there are no force-based solutions for existing problems...Attempts are being made to resolve the problem of Kosovo at the expense of the world's community, i.e. through creating a precedent going beyond the existing rules of international law. Our partners' inclination to give way to the blackmail of violence and anarchy is in clear contrast with the indifference shown in the case of Palestine.....The need to overcome the Cold War legacy is especially pressing in Europe....Even now we are facing a situation that can hardly be perceived as other than re-establishment of a cordon sanitaire West of the Russian borders.....Various attempts are being made to contain Russia. Thus the NATO expansion continues in violation of previous assurances given to Moscow that this scenario would not happen....The "containment of Russia" philosophy correlates well with unilateral plans to station a US missile defence base in Europe"*

Georgiy Bovt, formerly Editor of Profil, in the Moscow Times, March 7, 2007: *"Almost every politician – and now even rank and file journalists – tries to add his voice to the anti-US chorus. That chorus is no longer just singing – it is screaming, although just what it is screaming about is not exactly clear."*

Bovt, Moscow Times, May 3, 2007: *"What mutual understanding there might have been between Russia and the West is gradually being replaced by increasing mutual irritation, suspicion and even confrontation. The two sides no longer seem to speak the same language, nor do they care much for listening to each other....The sad preliminary result of Russia's last seven years of foreign policy is that Moscow is left without a single country in the world it can reasonably call a friend, ally and good partner...Increasingly Russians are taught to see themselves as living in a "besieged fortress", surrounded by an unloving, oppressive world community plotting against them."*

Alexander Solzhenitsyn, Interview with Der Spiegel, July 23, 2007: *"This mood started changing with the cruel NATO bombings of Serbia. ..All layers of Russian society were deeply and indelibly shocked by those bombings. The situation then became worse when NATO started to spread its influence and draw the ex-Soviet republics into its structure....The perception of the West as mostly a "knight of democracy" has been replaced with the disappointed belief that pragmatism, often cynical and selfish, lies at the core of Western policies. For many Russians it was a*

grave disillusion, a crushing of ideals....Did not Russia clearly and unambiguously stretch its helping hand to the West after 9/11? Only a psychological shortcoming, or else a disastrous shortsightedness, can explain the West's irrational refusal of this hand. No sooner did the USA accept Russia's critically important aid in Afghanistan than it immediately started making newer and newer demands."

Lilia Shevtsova, Carnegie Moscow Centre, in the Moscow Times, August 7, 2007:
"Being pro-Western in Russia today is not only unpopular but also dangerous because it necessarily means being anti-Russian".

Dmitri Trenin, Carnegie Moscow Centre ("Getting Russia Right", autumn 2007):
"Putin's Russia, in the Western public mind, joins Iran, Syria, North Korea, Cuba, Venezuela and Zimbabwe as a reviled regime. A resurgent, even revanchist Russia is turning into a cliché, evoking uncomfortable parallels with Weimar Germany."

General Nikolai Patrushev, Head of the Federal Security Service, October 10, 2007:
"Politicians thinking in the categories of the Cold War still retain their influence in a number of Western nations. They have claimed credit for the collapse of the Soviet Union and they are hatching plans aimed at dismembering Russia....[Foreign spies] are trying to influence protest feelings and demonstrations in Russia.....There is a danger of foreign NGOs being used to finance activities to undermine Russia."

Manual for Teachers distributed in Russia 2007: Josef Stalin: "the most successful Soviet leader ever".

The excerpts quoted above encapsulate the mood of Russo-Western political relations in 2007. In our 2006 Report to the Trilateral Commission, "*Engaging With Russia; The Next Phase*", Strobe Talbott, Koji Watanabe and I argued that megaphone diplomacy and name-calling on both sides might play well with sections of domestic opinion but became an escalating and counterproductive process which did nothing to advance policy and undermined the advocates of moderation and sensible engagement. Over the past two years, the volume knob on the megaphone has been turned up to, at times, deafening levels. If statements by politicians and interpretation by journalists are the yardstick, the relationship between Russia and Western Europe or the USA is at its lowest point for more than two decades. This has become a commonplace assessment. In an atmosphere of histrionic emotion and entrenched suspicion, verging on paranoia, it has become harder to form a balanced view or to argue for rational approaches founded on cool appraisal and set in a long-term perspective. Patience and perspective are not in fashion.

In this paper, against the background of last year's report, I shall try to explore ***why the relationship between Russia and the West has deteriorated so sharply***. Does this apply across the board? Should we regard it as a permanent shift (or, as some would have it, reversion to type)? I shall ask, as we did in Chapter 8 of last year's report, ***where Russia is heading***. What is the outlook for the next 5-15 years? Finally, I shall review the ***possible approaches open to the EU and the West***. Should we opt for containment or cooperation? Is partnership possible?

**THE DETERIORATING RUSSO-WESTERN RELATIONSHIP:
A “NEW EPOCH OF CONFRONTATION”?**

In his paper “A New Epoch of Confrontation”, Sergei Karaganov argues with his customary lucidity and vigour that the West and Russia are now in a new confrontation which differs from, and may be even more dangerous than, the Cold War – one in which the label of neo-imperialism “is put on virtually every thing that Russia does”.

I agree with Sergei that analogies with the Cold War do not stand up to any serious scrutiny and should be dismissed. The cardinal features of the Cold War were ideological conflict; the perception of a direct military threat from the Soviet Union to the West and vice versa; proxy conflicts, in which the USSR and the West took opposing sides in regional wars and disputes in Asia, the Middle East, Africa and Latin America; the subjugation of the states of Central and Eastern Europe to the Warsaw Pact and CMEA; and the isolation of the Soviet system from the capitalist world (with low levels of trade, different economic systems, and narrowly controlled exchange of information and human contact). Not one of these features exists today.

Self-evidently, we also agree that something has gone badly wrong in the Russo-Western relationship. Why?

Karaganov argues that Russia has become a target of Western propaganda attack even more severely than during the Cold War and is being blamed for intrinsic imperialism. The West, he says, has given up hope of turning Russia into an allied state and is thinking of “neo-containment”. When Russia was weak, the West failed to invite her to join the “club” of developed democracies as an equal yet junior partner. Now Russia is strong, mistrusts the West and is taking a tough line, while the West is nostalgic for “a feeble and weak Russia”. The most specific reason he gives for Western pressure on Russia is energy competition.

From my Western European perspective, I would attribute the malaise (which I would describe more in terms of animosity than, thus far, of confrontation – though the former risks leading to the latter) principally to five elements:

First, irrational though it may be, the legacy of the past ineluctably colours the relationship. Enlightened thinkers may deplore “Cold War thinking”, but history is ingrained in the mindset of our peoples, and historical emotions can be aroused with the greatest of ease by events – the poisoning of political opponents by persons unknown, missiles falling on neighbouring countries, bitter arguments over war memorials. These are serious matters in their own right, but their political effects are magnified by history (and all too readily manipulated by politicians and polemicists). The very word “NATO” has inescapably negative connotations in Russia. When Russia and Estonia came to blows over the Tallinn war memorial, it was not difficult for a third party to understand the deep grievances on both sides. It is not only in relations with Russia that we have to contend with the legacy of the past. One could quote hundreds of examples from around the world. Events 90 years ago still have a bitter effect on Turkish/Armenian relations. The partition of Ireland happened in 1922; the UK and Republic of Ireland joined the EEC together in 1972; but the Republic is one of the few countries to which the British sovereign has not paid a State Visit in her long reign. France and Algeria; Japan and China (and the Yasukuni Shrine); Japan and Korea; Germany and Poland or the Czech Republic; and so on, almost ad infinitum.

The Cold War ended only half a generation ago. The memory will linger on for at least a generation hence before it fades.

The Russians are reacting also to a yet more recent memory, which is under-appreciated in the West: the pain, destabilisation and humiliation of the 1990s. Their political system collapsed (which a majority welcomed), but without a ready-made alternative (to this day). Their economy collapsed, twice, which was painful and frightening. Their empire and country, previously a proud superpower, collapsed almost without warning, losing two fifths of its population and much of what was previously regarded as the heartland. They were sent food parcels and economic and political advisers. These nightmarish experiences happened only in the last decade, under the (misnamed) banner of “democracy”.

We should not be in the least surprised at the yearning of the Russian people to regain respect, strength, independence and “sovereignty” – which has been both reflected and directed by their political leadership. Nor should we be surprised that Russia’s leaders are currently overstating that renewed strength (much as Khrushchev vastly exaggerated nuclear capabilities in the 1950s). It took other former imperial powers (the UK, for example) fully half a century to adapt psychologically to their loss of status and to find a new equilibrium. But - despite Russia’s revisionist policies, Soviet-trained leadership, and the Soviet mindset extant in the older half of the population - Russia cannot and will not go back to the Soviet Union. As Dmitri Trenin of the Moscow Carnegie Centre, comments in his new book, “Getting Russia Right” (Carnegie Endowment, 2007): “Today’s Russia is different from the Soviet Union in so many ways that the idea of a USSR Version 2.0 would seem preposterous to any objective observer in Russia.”

Second, we are paying a price for disappointed expectations on both sides – *expectations*, which arose through naivety, ignorance and lack of understanding; *and disappointment*, which has been exacerbated by ancient suspicions. Solzhenitsyn has called this “the clash of illusory hopes against reality”. Trenin recalls that: “the idea, popular in the 1990s, that Russia would be integrated as a full-fledged member of the Western community inspired Russian democrats and their partners in Europe and America... Hopes were raised of a new Marshall Plan, early NATO membership, and some sort of a progressively tighter association with the EU... In the 1990s, when Russian elites wanted integration in principle, they dreamed of an instant accession to a position of prominence in each and every club they were seeking to join. Instead of going through obligatory and tedious homework on the path to joining, they hoped to use networking to reach a master deal with American and European elites. This approach went nowhere.”

There is a school of thought in the West which derides efforts to analyse and understand why the Russians are acting as they are – a school which camps on the view (typified by William Manthorpe’s letter quoted above) that Russia is irredeemably nationalistic (are not most countries?), xenophobic, anti-Western and condemned to authoritarian rule interspersed with brief periods of chaotic liberalisation. In an article in the International Herald Tribune of 1 October advocating the strengthening of Nordic defences against Russia, John Vinocur scorns “the current mantra which says that Russia needs respect and to be washed of all its past humiliations”. (He accuses George W Bush of falling prey to this mantra.) I tend to believe that the head in the sand is not the optimal posture for policy-makers; nor do I see a contradiction between seeking to understand Russian motives and maintaining appropriate defence of Western interests. The complexity of the triple transition in this vast country was wildly underestimated. From our own history, we should have understood that freedom is not

the same as democracy; that democracy has to grow from the bottom up; and that this takes a very long time. We turned a blind eye to Yeltsin's failings. Now we talk in anguished terms of the "de-democratisation" of a country in which democracy hasn't yet started.

This lack of understanding is mirrored on the Russian side. The legend has been implanted that the West mercilessly exploited Russia's weakness in the 1990s, and offered no help – which belies the truth. The continued existence of NATO is seen as offensive (although NATO has changed its doctrine, poses no threat to Russia, cooperates with Russia, and has self-evident reasons for continuing to exist). The accession of new members (a process which also poses no threat to Russia) is portrayed as an aggressive intrusion into Russia's sphere of influence. Sergei Karaganov reflects a widely held view when he says "When Russia was weak, it was not invited to join the "club" of Western democracies". So does Solzhenitsyn (quoted above) in lamenting that the West refused Russia's helping hand after 9/11. The fact is that Russia was welcomed into a number of democratic "clubs" in the 1990s and before and after 9/11 – to the maximum extent possible.

In the 1997 Partnership and Cooperation Agreement with Russia, the EU declared "a strategic partnership founded on common interests and shared values". Russia joined the IMF and the Council of Europe. President Yeltsin was invited to G7 Summits. The G7 was then enlarged to G8; and – at the Summit following 9/11 – President Putin was given the accolade of hosting (in 2006) the premier "club" of the largest industrialised democracies – a club to which neither India nor China has yet been admitted. At the same time, at the initiative of Tony Blair and as a direct consequence of the post 9/11 partnership, the NATO-Russia Council was established. These are but the leading examples among many. From which "clubs" has Russia been excluded? Russia has not applied to join, indeed does not wish to join, the EU (in the unlikely hypothesis of Russia wishing to join and the EU agreeing, it would take many years for the Russian economy and political system to achieve the necessary alignment). Russia has not applied to join NATO. The WTO is not a "club" of democracies, but a rules-based trade body: Russia's accession negotiations, though slow, are well advanced. And the OECD, a club of lesser stature, is considering Russian membership. Such are the facts; but what matters politically is that there is a perception within Russia of rejection and exclusion – a perception felt most strongly by pro-Western Russian liberals.

Third, there are genuine and substantive differences of interest and policy between Russia and Western countries. Rows about NATO enlargement or the possible stationing of a handful of interceptor missiles in Poland or the gesture politics of renewed patrolling by antiquated Bear reconnaissance aircraft over the North Sea may have been played up for political reasons. On many important global issues – such as terrorism, WMD proliferation, the environment – there are no fundamental differences between Russia and the West. However there are clearly areas where our interests diverge. Russia takes a different view of Iraq from that of the US and British Governments, though its view is widely shared in Western Europe. In the Middle East generally, in Asia, and in certain parts of Africa and Latin America, Russia is pursuing its interests more actively, often competing with Western interests, but not in a way which can be labelled illegitimate or deliberately confrontational. Where it has the means to do so, it is seeking to reassert its role as a global power.

Beyond areas within the zone of normal competition, there are also issues over which Russo-Western relations risk tipping into confrontation. These include the handling of Russia's neighbours; Kosovo; and Iran. I shall return to this in the final section.

Fourth, the conflict of values is an obstacle to partnership. In the article quoted above, Foreign Minister Lavrov sought to exclude values from intergovernmental relations: “The Westphalian system, which has become a fashionable object of criticism in certain circles, has placed differences in values beyond the scope of intergovernmental relations. In this respect, the Cold War was a setback. Should we really follow this path back, which can only lead to confrontation?” Should this argument be applied (taking it to an extreme: I am not making an analogy with Russia) to Burma? It is a little reminiscent of Andrei Gromyko’s position before the Helsinki Final Act; and it is not realistic. Russia has joined the Council of Europe and signed the European Convention on Human Rights. It has signed documents declaring that it shares the values of the EU, and has joined the G8’s club of industrialised democracies. States, which do not share values, of course cooperate where they have interests in common. But genuine partnership, joint membership of democratic clubs, demands a commonality of values. The perception that our values are not converging, especially with regard to the rule of law, has inevitably damaged the atmosphere of Russo-Western relations – the handling of the murders of Litvinenko and Politkovskaya being cases in point.

Fifth, differences have been played up for reasons of domestic politics. This happens on both sides. As Fyodor Lukyanov (editor of “Russia in Global Affairs”) commented in the Moscow Times on 7 March: “The escalation of aggressive rhetoric we are witnessing is capable of reviving the outward appearance of the Cold War, which will do nothing toward providing real security, inasmuch as the real threat does not come from any real conflict between Russia and the West. But it is far simpler for politicians on both sides to fall back into familiar patterns of behaviour than to try to resolve the real problems they actually face.”

Exaggerating the threat of an external opponent is an age-old political gambit. Russia entered an ideological vacuum and an identity crisis in 1991. Some argue that anti-Westernism has now become the new “national idea”; that xenophobic nationalism is being used to bind the nation together. Certainly the oft-repeated assertion that the West is trying to subvert and weaken Russia has its uses. It can be used to justify increased central control over civil society, limitations on civil and political rights and the reinvigoration of the internal security organs. Blame can be diverted onto external opponents. And now that the flow of critical opinion into the country can no longer be blocked, discrediting external critics as malign and destabilising forces is the most effective counter-attack. Russia’s anti-Western rhetoric is above all being aimed at the domestic audience.

WHERE IS RUSSIA HEADING? THE MEDIUM-TERM OUTLOOK

Our Report in 2006 noted that Russia had experienced a period of reform under Yeltsin followed by retrenchment (and disorder); and a period of significant reform and initial convergence with the West under Putin, up to 2003, followed – as its new wealth became evident - by retrenchment, centralised control and a more hard-nosed relationship towards the West. Following the forthcoming Duma and Presidential elections, Russia is set to enter a third term of Putinism. What should we expect?

The apparent short-term prospect is for continuity rather than change – but this needs to be qualified.

President Putin has long indicated that he wished to respect the term limits in the Constitution by giving up the Presidency; but also intended to keep his hand on the tiller. His continuation

in power would evidently be popular with a majority of the Russian electorate (and, incidentally, of foreign investors). However there is deep uncertainty within the elite about how Putin can achieve his objective while giving up the Presidential office. Many see this as an insoluble problem, within the constitutional and historical framework of a country geared to a single strong ruler. Putin has recently said (in terms short of a definitive commitment) that he would consider the post of Prime Minister. However, to retain sure control, he would need either to amend the constitutional law (rather than the Constitution per se) in order to transfer powers from the President to the Prime Minister; or to persuade the next President (who is certain to be his own nominee) to step aside, perhaps at an early date, so that Putin could resume the Presidency. Many other variants have been floated whereby Putin might seek to retain control without remaining President; but none resolves the conundrum. Any of the possible variants could lead to a weakening of the authority and legitimacy which Putin has exercised since 2000.

The uncertainty is destabilising the ruling elite. Infighting between Kremlin clans has begun to spill out in to the public arena. There is a growing risk of freelance activity by these groups as they fight for the spoils of power. It is hard to see them accepting the future leadership of anyone other than Putin – and there must be a question-mark over the ability of Putin himself to continue to act as the arbiter and ring-master. The months leading up to the selection of the next President in March, and no less the months afterward, are set to be a fraught period while the internal balances of power and personnel are resolved.

What about the medium to long term?

Russia has rebounded impressively since the 1998 crash. GDP was \$260 billion in 2000; in 2007 it will be around \$1.3 trillion. Inward FDI rose from \$13 billion in 2005 to \$29 billion in 2006 and is forecast to reach \$50 billion this year. The number of people living below the poverty datum has halved from 29% in 2000 to under 15% now. Can this advance be sustained? Will Russia's power continue to grow over the next 10-15 years? How will it be used?

In the 2006 Report, we argued that Russia had the capacity to become a strong and competitive modern state – one of the most advanced economies – if it utilised its human capital as well as its natural resources; but we did not feel that current policies would achieve this goal. The opportunity would be missed unless effective action was taken to address some deep-seated challenges.

The challenges remain. Some of the most significant are:

- **Political development:** The control and stability engendered by President Putin (in marked contrast to the 1990s) has been important to Russia's recent success; but dependence on a single institution and a single personality is also a point of vulnerability. Political stability depends on the vertical of power transmitted down from the Kremlin through the President's appointees (most of those in key positions being personally linked to him through the KGB or St Petersburg or both), with the adroit and hugely popular figure of Vladimir Putin at its apex. The question of the eventual succession to Putin will not go away.

Putin himself has recognised that the absence of any other effective institutions does not make for long-term stability: "We cannot build Russia's future by tying its many

millions of citizens to just one person or group of people. We will not be able to build anything lasting unless we put in place a real and effectively functioning multi-party system and develop a civil society that will protect society and the state from mistakes and wrong actions on the part of those in power” (to the Valdai group, September 14).

- **Dependence on natural resources:** Just as Russia is over-exposed to a single leader, so its economy is over-exposed to world commodity prices and demand. Oil and gas account for about 60% of export revenues; precious and base metals for a further 10%. Russia’s huge currency reserves and oil stabilisation fund provide a substantial cushion against falling revenues. If the global economy were to slow down and commodity prices fall, as some experts are predicting, the effect would be felt particularly strongly in Russia.
- **Corruption and bureaucracy:** The state bureaucracy remains essentially unreformed. Meanwhile the evidence suggests that corruption is getting even worse; is seen by businessmen as a major obstacle; and is a source of growing public discontent.
- **National champions, monopolies, and the State’s role in business:** Some private sector businesses closely linked to the Kremlin have been built up as quasi-monopolistic “national champions”; and the scale of businesses in which the State has majority ownership continues to increase. The performance of the State-owned businesses tends to compare poorly with private sector counterparts – Gazprom being a prime example. The Kremlin is promoting a model of economic development which has failed elsewhere and which is damaging to productivity and competitiveness.
- **Demography and mortality:** Russia’s falling population and high rate of male mortality set it apart from the other fast-growing emerging economies and threaten future growth.
- **Education reform** has been blocked or watered down, and spending on education is projected to decline from 4.1% of GDP this year to 3.7% in 2010.
- **Widening income disparities, poor public healthcare and inadequate social protection** threaten to become more serious sources of social tension.

Russia’s renewed self-confidence and assertiveness has been based on its economic growth, and in particular on the leverage of its oil and gas production in a time of high and growing global demand. These factors are not likely to change dramatically. However the prosperity generated by high oil has masked the structural weaknesses of the Russian economy. While the Kremlin has declared its intention to boost investment in infrastructure and is seeking to promote innovative industries, some of its policies have exacerbated those weaknesses. The poor performance of the two large State-owned energy companies, Gazprom and Rosneft, should be a particular cause for concern. Russia could be approaching a plateau at which the recent high growth rates of 6-7% will prove unsustainable, while pressure increases from the least advantaged sections of society for better services, less corruption and a fairer distribution of wealth. Responding to this would present a considerable challenge to the country’s leadership.

Sergei Karaganov concludes that Russia’s share of world GDP will decrease if it cannot achieve sustainable growth of 8-10% annually; and that the country needs a transition to a

knowledge economy, modernisation of the political system and a new development model if it is not to decline in the next “epoch” (ie 7 or so years hence, on his assessment). A change of approach in favour of renewed modernisation would be the rational course for Russia’s leaders, and this in turn would entail a deepening of Russia’s economic links with the West. Russia’s leaders, of course, do not always choose what we might regard as the rational option; but if they opt for stagnation, the West could eventually find itself contemplating again, not a strong Russia, but the more worrisome prospect of a weak Russia.

WHAT APPROACH SHOULD THE WEST TAKE?

Although the Russians see it differently, Western policy from the early 1990s was to try to help Russia through its economic difficulties, assist the transition towards a market economy and (it was hoped) democracy, promote Russia’s integration into the global political and economic system, and seek to build a genuine strategic partnership with Russia – so that we could act together to deal with global problems and threats.

During President Putin’s first term, significant progress was made towards “strategic partnership”. Since 2004, however, it has become increasingly clear that the dominant forces in the current Russian leadership do not want such a partnership. They do not wish to be constrained by it. They do not wish to embrace the responsibilities it would require. They mistrust the motives of the West – a mistrust which was barely dormant and has been reawakened by certain events and Western actions, and by Western criticism of Russian behaviour. They also believe that Russia’s renewed strength from hydrocarbon wealth means that they do not need such a partnership: that Russia no longer needs to make concessions to Western viewpoints, but can dictate its own terms for cooperation – whether over arms control issues or energy or Iran or Kosovo. As Karaganov says, Moscow “does not want and cannot afford to integrate with the traditional West on the terms the latter proposed just recently...Russia has made the decision that it will not join this club; and if it does ever decide to join in the future, it will do so as a strong power.” Or, in Putin’s words, “Russia will either be independent and sovereign or will most likely not exist at all.”

The West must therefore accept that **partnership** with Russia is not, for the time being, an operable policy. The Russians have rejected it; and they believe that the West has rejected them. We should take the Russians at face value; give up talking about partnership; and cease basing EU policies on this chimera.

We now face a situation in which there is a significant risk that mistrust, misreading of intentions, miscalculation, disillusionment, domestic politicking, and bitter emotions could – as an unintended consequence – tip the relationship from competition into confrontation.

It is not hard to identify issues which could have this effect. They include:

- **Arms Control:** At the time of writing, the consultations between the United States and Russia over theatre missile defence appear to have slim chances of producing agreement. Russia’s reaction has been to threaten to withdraw from the INF agreement and CFE treaty. This is clearly intended to bring pressure to bear on the European allies of the USA. But the consequences would be serious were Russia to resume building intermediate-range missiles targeted on Europe.

- **Kosovo:** The December deadline for resolution of Kosovo's status, and Russia's threat to veto independence, look like an approaching train-wreck. The USA wishes to call Russia's bluff. So do some in Europe – but there, as usual, divisions within the EU. Russo-Western cooperation survived previous crises over the Balkans, but in a more benign environment; and lasting damage was done. Russia has fraternal and historical ties with Serbia, and some economic interests; but, in contrast to the EU, can no longer claim to have vital strategic interests in the Balkans and, crucially, shows no signs of willingness to help shoulder the burden of resolving problems in the region and promoting peace and stability there. If their policy is simply to obstruct, the Russians will ultimately compel Western policymakers to sidestep the obstruction by ignoring them. This could trigger Russian counter-actions over Abkhazia and the other frozen conflicts in the Caucasus. In an electoral period in Russia, hard-line nationalist sentiments will be to the fore. Containing the Kosovo fall-out looks difficult.
- **Georgia:** Irrespective of the knock-on effects of Kosovo, the Russo-Georgian relationship remains a tinderbox into which elements on either side could throw a lighted match. With Saakashvili's administration under considerable pressure internally, some in Georgia might see advantage in provoking a confrontation with Russia in the hope of inducing the West to send in the cavalry (and of accelerating Georgian entry into NATO). Likewise there are elements in Moscow who feel that Russian policy has been too restrained, and would not be averse to teaching the bumptious Georgian regime a lesson it wouldn't forget.
- **Ukraine:** Ukraine is seen by the Russians as quasi-domestic territory – a country where they have every right to interfere, but where Western involvement is a hostile incursion. Were the (currently stalled) question of Ukrainian membership of NATO to come back to life, the Russian reaction would be very sharp.
- **Iran:** As Putin's impending visit to Teheran underlines, Russia has a distinctive position on Iran at odds with that of the West. Russia has reservations about the Iranian regime, but maintains trade and friendly relations with it. It hopes thereby to neutralise any potential threat from Iran, and to gain a position of advantage. Russia would prefer not to have a nuclear-armed Iran; but, in private, Russian officials see no acceptable way of impeding the Iranian weapons development programme. They argue that sanctions would be counter-productive, and the use of force disastrous. Up to now, Iran has been a source of tactical rather than strategic disagreement between Russia and the West. But if the USA were to use force against Iran, the Kremlin would come out strongly on the other side (and might well supply additional armaments to the Iranians).
- **Energy:** Russia has used the leverage of energy supply in its relations with Estonia, Lithuania, Belarus, Ukraine and Georgia. There is a growing divergence between, on the one hand, the EU's intention to diversify sources of supply and the Commission's proposals to build an integrated and unbundled energy market; and, on the other, the Russian concept of a grand energy compact and of long-term gas supply contracts with individual EU countries. Russia has also sought to undermine the Nabucco pipeline project designed to bring gas from Azerbaijan into the EU through Turkey.

This is far from an exhaustive list of possible sources of a deeper rift. What broad approach should the West adopt in the face of these risks? If integration was a

misconceived idea of the early 1990s and “strategic partnership” is now exposed as inoperable, what are the alternatives?

Karaganov and Trenin (among many other Russian commentators) express the fear that the West, as Karaganov puts it, is showing “signs of a transition to a policy of ‘neo-containment’”. There are those in the West who advocate such a policy, but they are on the fringe – in my view rightly so. They include polemicists who reach simplistically for the word “appeasement” as an instrument of abuse. No major Western government or organisation is pursuing “neo-containment”. Such a policy would only make sense if Russia posed a general threat to Western interests and if we were no longer able to cooperate in pursuit of common interests. Neo-containment would effectively mean the neo-isolation of Russia. The case against isolation scarcely needs arguing again.

What has emerged instead is a surprisingly broad consensus in favour of the sort of hardheaded and practical engagement – since “neo” seems to be the prefix of choice one might call it “neo-engagement” – which was advocated in last year’s report to the Trilateral Commission. Even the tougher advocates of tough love want to widen engagement with Russia, not cut it off. For example, Senator McCain, in his *Financial Times* article of 13 June (“Why we must be firm with Moscow”) wrote that “Clearly we in the West must pursue cooperation with Moscow where we can”; supported Chancellor Merkel’s suggestion to construct a transatlantic marketplace and invite Russia to join when it met benchmarks on rule of law and economic freedom (NB not democracy); and advocated expansion of scholarship and exchange programmes. The Task Force of the Council on Foreign Relations (“Russia’s Wrong Direction”, 2006) also argued for selective cooperation. The Hudson Institute Symposium (“US-Russian Relations: Is Conflict Inevitable?”, summer 2007) wanted the US to “strengthen its contacts with Russian civil society, encouraging exchanges and business contacts, easing the visa regime, and expanding broadcasts.... The West can aid the Russian liberal project indirectly through its wide contacts with the Russian population”).

In “*Getting Russia Right*”, Trenin makes a strong argument that Western elites still think of Russia in terms of the 1990s and apply the democracy paradigm to it. He contrasts this with the way the West has welcomed – not sought to retard – the rise of new powers in which democracy is absent or imperfect (notably China, but also Brazil, Argentina, South Africa, Indonesia, Kazakhstan), applying the paradigm not of democracy but of emerging capitalism and what he calls “the expansion and entrenchment of Western ways and institutions”. With a few exceptions, of which the most conspicuous is India, he notes that the “westernising nations” are not mature democracies; but they will need to build political institutions, and establish property rights and the rule of law, if they are to secure their future capitalist development. The same can be said of Russia:

“Over time, Russia will acquire more and more rightful owners: from a few dozen today to a few hundred several years from now to hundreds of thousands. Within a generation, having a single master of the land will first become impossible and then unthinkable. The powers of government will have to be separated in reality.... Governance and competence are likely to emerge as criteria for grading the political regime and determining its fate. Russia circa 2025 will still not be a democracy, but it will be considerably more liberal and modern. The liberalism that has a chance to prevail in Russia will be economically driven. American and European foreign policy should seek to strengthen the forces of liberalism and modernisation in Russia. Market forces can be relied upon to open up Russia even wider and help transform it even more deeply, but they need encouragement.”

So what should be the characteristics of a policy of “neo-engagement”?

In outline:

- The West must recognise that *change in Russia will come from within, and over a long period*. To the extent possible, it should continue to support processes of enlightenment there – but should not gear policy to unrealistic expectations of the pace of change or to unachievable benchmarks.
- *The influence of the West* will be felt predominantly through the power of example, the flow of information and human contact.
- *The two-way interaction of business* and the further development of the market economy in Russia will be the most powerful driver of the modernisation of society and governance.
- *Growing economic interdependence* is already a constraint on negative behaviour, and will become an even stronger one in the future.
- *Russo-Western relations are likely to remain in a trough* over the next five or so years. The West should defend its interests firmly, but seek to do so in a way which avoids all-out confrontation.
- Instead of strategic partnership (and grand, over-arching agreements), *the West should seek cooperation on specific strategic issues*. Security and stability in Europe and the Middle East, opposing international terrorism and the proliferation of WMD, and prevailing in the conflict in Afghanistan should be high on a list of common strategic interests.
- *The EU needs a shared analysis of Russia and a unified approach*. Solidarity makes an impact, as the Samara Summit demonstrated.
- This approach should be based on *clearly stated principles*, including that the European Union:
 - Is resolutely opposed to a new division of Europe and commits itself to work over time for the progressive dismantling of barriers.
 - Recognises that a strong, stable, prosperous and modern Russia will make a very large contribution to the well-being of the European continent; and seeks to cooperate with Russia to the greatest extent possible.
 - Fully acknowledges Russia’s right to defend its own interests and pursue its own independent policies within the parameters of international law and of the sovereign rights of other states.
 - Has an equal interest in the sovereignty, stability and development of the Russian Federation and of all of the other states of the former Soviet Union, and in harmonious relations between them.
 - Is not seeking to expand its influence at the expense of Russia, but will oppose any encroachment on the sovereign rights of any European state.
 - Will defend its own interests and values robustly where they are challenged.

CONCLUSION

As we noted in the earlier Report, “control” has been a leitmotif of President Putin’s administration thus far. Control by the Kremlin and the organs of security. Control of the Government, the regions, the Duma and political life, and of civil society. The Kremlin would like to control or neutralise external opponents and critics as it does internal opponents. The control of business has increased: control over the most valuable natural resources, the growth of Kremlin-run State-owned corporations and of influence over the largest private sector companies. Asserting its sovereignty and independence, and using the instrument of energy supplies, the Kremlin seeks greater control over its neighbours and over Russia’s external relationships, modelling Russia on a 19th century great power rather than on 21st century globalised interdependence.

The reassertion of control underlies Russia’s resurgence. It has had manifest benefits. Russia is much more orderly than in the previous decade. It has a degree of predictability. The country’s economy has surged forward, with the high oil and gas revenues channelled by strong macroeconomic management. Russia has become very attractive to direct and portfolio foreign investors. So long as they align with the regime’s objectives, foreign companies do well there: as a place to do business, Russia compares reasonably well with other emerging markets.

There is also a downside. Control depends too heavily on a single personality – and is therefore coming under strain as the President nears the end of his second term. The model does not make for economic efficiency. Without modernisation, there is a risk that the economy will stagnate. In external relations, the reassertion of old-fashioned power is causing serious friction.

We should not assume that the Soviet mentality, which permeates the present ruling elite, will be an unchanging characteristic of Russia’s future. This would be to ignore the extent to which Russian life beyond the Kremlin has changed over the past 15-20 years and will continue to change (not always in a direction desired by the West). Karaganov sees the phase which he calls the “New Epoch of Confrontation” as being of relatively short duration. He suggests that, in 5-7 years, attitudes in Europe and Russia will have changed. At that point “Russia will come down to earth after its present euphoria and will conduct a more cautious, although not less active, policy.” I agree: by around 2015 and certainly by 2020 it seems highly probable that internal pressures and the downside of the Kremlin’s current prescriptions, plus the effects of generational change, will lead towards a more rational atmosphere in Russo-Western relations.

A deliberate policy of containment would lock us into an across-the-board confrontation and throttle channels of cooperation unnecessarily and to the huge disadvantage of the West and of progressive elements in Russia. The only beneficiaries would be precisely those revanchist and isolationist elements in Russia who wish to return to a state of mutual hostility.

At the end, it boils down to a judgement call. There is a crucial difference between a regime which is seeking to assert its sovereignty and push its power to the limits, and one which is set on confrontation.

Russia has enjoyed becoming a more awkward customer for the West. But I do not believe that the Russian leadership intends, or thinks it can afford, a generalised policy of confrontation with the West. The EU and its Western partners should be no less assertive than the Russians in standing up for their interests; but Western policy should not be based on a misplaced presumption of confrontation.

A NEW EPOCH OF CONFRONTATION¹

SERGEI KARAGANOV

Dean of the School of World Economics and International Affairs of the State University–Higher School of Economics; Chairman of the Presidium of the Council on Foreign and Defense Policy; Chairman of the Editorial Board of “Russia in Global Affairs”, Moscow

Global politics, of which relations between the traditional West and Russia make up an essential part, is acquiring a new quality. Many analysts have been impatient to call the changes a “new Cold War.” However, the causes and forms of the confrontation, occurring right before our eyes, markedly differ from the sources of the confrontation that ended almost 20 years ago. The new confrontation is proceeding in different conditions and, most likely, it will be less profound – although it may be even more dangerous – than the confrontation of the past.

Let us describe this stage as a “New Epoch of Confrontation” (NEC). Basically, it differs not only from the Cold War period, but also the period that began in the late 1980s and is coming to a close now. The main feature of the last 15 years was the economic, ideological and geopolitical triumph of liberal-democratic capitalism (above all as represented by the United States), and the redistribution of labor, economic and financial resources in favor of those countries that followed this model. Now, however, the situation is changing.

Manifestations of NEC

Russia has recently become a target of the West’s propaganda attack. Paradoxically, Russia is now coming under political attack even more severely than the Soviet Union was, although – unlike the U.S.S.R. – today’s Russia is not trying to impose its ideology on the rest of the world and is not confrontation-minded. In the Soviet years, it was the Communist regime, not the Soviet people, which was the enemy of the “free world.” Now it seems that the West wants to blame Russian President Vladimir Putin, as well as the rest of Russia, for what it perceives to be intrinsic imperialism.

In the 1990s, any attempt by the Kremlin to halt the panic retreat caused by the collapse of the Soviet Union was immediately branded as “neo-imperialism.” Now this label is put on virtually everything that Russia does. Things have reached the point of absurdity as Moscow is now stigmatized for expansionism and the policy of pressure when it subsidizes the economies of neighboring countries by selling them energy resources at reduced prices, and then again when it decides to switch to market prices.

Russia is not the only target of propaganda attacks; China was another target in the late 1990s. Washington, however, opted not to wage an openly hostile policy toward China (although such a possibility was discussed), choosing instead a policy of soft containment. China proved to be too strong and invulnerable and did not yield to

¹ The article was published in Russian in *Rossiia v globalnoi politike* (4/2007) and is to be published in English in *Russia in Global Affairs* (4/2007).

provocations, or did so in a well-planned and very tough way. It was careful not to get involved in a Cold War that was proposed to it.

In contrast, Russia began to return the criticism, sometimes even taking the dubious lead in the verbal exchange. The desire to always respond to criticism –more effectively and in even more scathing terms – is rooted in the lingering inferiority complex, which is intensified by the geopolitical defeats of the 1990s, as well as by the apprehension that less-competitive members of the elite had toward their challenging neighbors. Some Russian politicians might have thought that an aggravation of relations was useful for forming a new Russian identity, and for restoring sovereignty and governability of political processes, including the transfer of power. We are beginning to play according to the rules that are being handed to us, thus getting involved in rhetorical confrontations that our rivals seem to be provoking deliberately.

An analysis of recent developments suggests that the United States and part of the traditional West have given up any hope of turning Russia into an allied state. There are signs of transition to a policy of “neo-containment.” At the same time, Moscow realizes that it does not want, and cannot afford, to integrate with the traditional West on the terms the latter proposed just recently – that is, a kind of integration without the right to vote. The Kremlin has begun to change the rules of the game, or at least it is ceasing to play according to the old rules of the 1990s.

Why the NEC began

The most obvious reason for the introduction of this New Epoch of Confrontation is the increased readiness and ability of revitalized Russia to uphold its interests. Moscow’s tough policy and almost total mistrust toward the West is the price for the strategic mistake made by Western powers in the previous decade. When Russia was weak, it was not invited to join the “club” of developed democracies as an equal yet junior partner. Now Russia has made the decision that it will not join this club; and if it does ever decide to join in the future, it will do so as a strong power.

Moscow has learned its lesson and has started to behave toward other nations the way they once behaved toward Russia. The West’s reaction to Russia’s behavior is worsened by its nostalgia for a feeble and weak Russia, a bad habit for which Western political elites developed over the previous decade. Yet, the causes of this resentment go much deeper.

Ineffective attempts by the European Union to shape a common foreign policy (conducted by the lowest common denominator) are increasingly weakening the united Europe. Consequently – after years of growth in the 1980s and the first half of the 1990s – the foreign-policy influence of the leading European nations is decreasing.

Now, Russia also must pay for the Europeans’ mistakes. First, general feelings of weakness, characteristic of today’s Europe, increase European resentment about the reviving Russia. Second, the EU’s inability to consolidate on the principles of common sense leaves Russia without a potentially key partner on the international stage.

In the 1990s, many people believed that the United States was destined for sole global leadership and even hegemony. However, the reckless Iraqi campaign showed

that America's overwhelming military supremacy does not transform into foreign-policy effectiveness. The "soft power" of the United States – that is, attractiveness of the U.S. model of political and economic development – was dealt a crushing setback. Even worse, Washington's failure made democracy per se, which the U.S. had attempted to impose by force, less attractive.

Against this unexpected weakness on both sides of the Atlantic, Russia's rapid foreign-policy rise makes a particularly strong impression. It would be fair to say, however, that this rise is not only due to the revival of the Russian state, its economic growth and a competent and steadfast foreign policy, but also due to pure luck.

In the late 1990s, the geopolitical wind began to fill Russia's sails. The role of global energy supplies increasingly became a factor in global politics; long-term destabilization of the Greater Middle East began; and the governability of the international system decreased. All these factors, including the bombings of Yugoslavia and Iraq, increased the role of military force. Russia, despite its difficulties, is still the world's second largest military power; it has proved its readiness to use force and even emerged victorious in a war against Islamic radicals and separatists in Chechnya (although at a horrible price).

Even the economic and geopolitical growth of China now plays into Moscow's hand: Washington seriously fears an alliance between Russia and China. Other factors that have strengthened Russia's positions include North Korea and, more importantly, Iran's desire to acquire a nuclear potential, as these problems cannot be solved without Moscow.

European and American elites are very anxious about Russia's growing energy might, while Europe's dependence on energy imports, above all, from Russia, will only grow. This is particularly frightening for the Old World, considering Russia's new tough policy, which often is very clumsy in form.

Energy competition is perhaps the main reason for the pressure on Russia. If the Europeans agree to a historic deal proposed by the Kremlin – namely, permitting Russian companies to energy distribution networks in Europe in exchange for permitting Western companies access to hydrocarbon fields and extraction facilities in Russia – then the differences that derive from this competition could be overcome to mutual benefit. Thus, a single energy complex would be created on the European continent, which would greatly strengthen both parties and allay many fears. Officially, Brussels has rejected the Russian proposal, although individual transactions are already being implemented. A mutually advantageous compromise is still possible unless political circumstances – for example, pressures from the United States – disrupt the discussions.

A unified energy complex throughout Europe is not in the interests of the U.S. If the European Union reaches agreement with Russia and reduces its dependence on non-European energy sources, it will reduce U.S. influence in Europe, as well as Europe's dependence on America. The United States alone has the political and military capabilities to guarantee access to resources for itself and its allies.

Washington continuously rejects any possible deal between Russia and the EU. This situation resembles the fierce struggle that Washington waged in the late 1950s until the early 1980s against the development of energy cooperation between the Soviet Union and West European countries. The U.S. lost that struggle, and export-oriented gas and oil pipelines were built from the Soviet Union to Western Europe. Now America is struggling not only against Russia's rise, but also against the strengthening of Europe, or rather against the weakening of its own positions in the Old World. One can only hope that differences with the U.S. on this issue will subside.

The bitter rivalry over energy is due to one more fundamental change that has taken place in the world over the last 8 to 10 years. Until recently, the bulk of the world's energy resources were owned or controlled by Western companies. Today, a greater portion of the world's energy resources, beyond the borders of North America and Europe, are owned or controlled by national states or state-run companies. The rules of the game are changing before our eyes. The era of the "Seven Sisters," when the Western oil giants had total access to energy resources is coming to an end. We are witnessing the defeat of a major element of U.S. and Western policy of the last 60 years: ensuring control over energy-producing countries in order to gain unimpeded access to cheap energy resources from the Third World, where the bulk of these resources are concentrated.

Many analysts in Moscow argue that the political and propaganda pressure being exerted by the West on Russia is the result of Russia's growth. This conclusion is only partly right. "To be sure, mounting Western concerns about Russia are a consequence of Russian policies that appear to undermine Western interests, but they are also a reflection of declining confidence in our own abilities and the efficacy of our own policies," wrote Thomas Graham, until recently a senior advisor on Russia with the U.S. National Security Council, in *Russia in Global Affairs* (July-September 2007).

This Western pressure is more of a counterattack against Russia than a direct attack, intended to prevent a further weakening of the West's positions and possibly win them back. This counterattack is an important constituent feature of the NEC.

Russia has found itself on the front lines of this new redistribution of power and influence in the world, and thus in the field of fire. Moscow's rejection of strict control over its energy resources, followed by their privatization in the 1990s, created the impression that the West's energy security had been drastically strengthened. However, over the last few years, Russia has restored control over its resources in one way or another, thus becoming the most visible part of the new redistribution. Moscow, now feeling much stronger, has wasted no time trying to win back some of the positions it lost or abandoned in the 1990s. However, the West, which is seeking to prevent any further weakening – a weakening that has been caused by its own policies, not Russia's – has countered its counterattack.

Economic foundation of NEC

There is yet another aspect to this bitter global rivalry, namely, the emerging struggle between two models of development – liberal-democratic capitalism of the traditional West, and "authoritarian capitalism" led by the Asian "tigers" and "dragons." The West considered the rapid economic progress of the authoritarian Southeast Asian countries

and South Korea to be an exception rather than a rule. However, China's rapid growth, despite predictions over the past 20 years about its imminent collapse, does not permit indulging in escapism anymore.

The victory of liberal-democratic capitalism in the Cold War created an illusion that this victory was final. The "end of history," predicted by Francis Fukuyama, has not materialized, but not simply because the collapse of the bloc system has brought about growing chaos. As it turned out, competition is not over: the defeated planned socialist economy has been replaced by a new model which potentially is very attractive, especially to the former Third World countries – that is, the majority of humanity. This model is authoritarian semi-democratic capitalism, effective economically and acceptable politically.

Unlike Communism, capitalism ensures the growth (albeit an uneven growth) of the wellbeing for the majority of people; and unlike totalitarian Communism, authoritarianism – or limited democracy – ensures an acceptable level of personal freedom for the same majority.

The rivalry between the two varieties of capitalism was analyzed by Israeli strategist Azar Gat in the influential U.S. journal *Foreign Affairs*. "Authoritarian capitalist states, today exemplified by China and Russia, may represent a viable alternative path to modernity, which in turn suggests that there is nothing inevitable about liberal democracy's ultimate victory – or future dominance," he wrote. "A successful non-democratic Second World could then be regarded by many as an attractive alternative to liberal democracy."

It may well be that "authoritarian capitalism" is only one stage in the development toward a more liberal model. After all, before the second half of the last century, many countries in Western Europe and the United States had features that are now characteristic of those states that have so-called authoritarian capitalism.

Nevertheless, the liberal-democratic victors now see that they are beginning to suffer defeat. The "mission" in the Middle East has weakened the global position of the United States, which in turn has made democracy per se less attractive. Furthermore, the mostly unsuccessful 'color revolutions' imported to former Soviet republics was a less noticeable, yet substantial, blow to the idea of democracy. Meanwhile, the democratic elections in Palestine have plunged the country into a civil war. Lebanon, which is quite democratic, has been set on fire, while its neighbor – the authoritarian Syria – is developing quite well.

The competition of models is not just a struggle for the sense of moral superiority. In the long run, the victory of a particular model will be translated into a redistribution of human and other resources in favor of those states that support such a model. The period from the late 1980s to the beginning of the 2000s saw a huge redistribution of resources in favor of the United States and Western Europe. Now the process may reverse itself, especially as the success of authoritarian capitalism and the weakening of the positions of democracy have coincided in time with another tectonic shift: the center of the global economy and geopolitics is moving away from the Euro-Atlantic to the Asian space.

States that are liberal-democratic yet economically weak must automatically orient themselves to the West and follow in the wake of its policy. However, if another model proves successful, some states will have an opportunity to reorient themselves, or at least have more room for maneuver.

Russia, for example – by demonstrating to the post-Soviet and developing countries that they can successfully organize their economies in other ways, and not only according to the model of the dependent liberal-democratic of Central and Eastern Europe – is restoring, albeit very slowly, its ability to attract medium-developed societies and countries. Many neighboring societies, tired of poverty, chaos and uncertainty, are eager to emulate the sovereign system of Russia, which is showing growth and is better governed. In addition, authoritarian rulers of many states prefer to have a tough yet predictable Russia that would not encroach on their sovereignty as their neighbor.

History has pushed Russia into the center of a new competitive struggle between the liberal-democratic and authoritarian models of capitalism. Russia is a key state from the point of view of competition between political and socio-economic models, and is, moreover, capable of tipping the military-political balance in the world.

Mistrust toward the authoritarian development model largely explains European suspicion about Russia's energy policy. An authoritarian state finds it easier to manipulate its energy and other assets for foreign-policy purposes. In this sense, democracy, especially weak democracy, is more convenient for partners, as it is less suited for such manipulation.

So, Russia is now in the midst of two new competitions at once, which will largely determine the future of the world. These are competitions between energy producers and consumers for control over energy resources, and between different varieties of capitalism. Moreover, Russia is situated on three critical divides – between radical Islam and Christian civilization, between the rich and the poor, and between Europe and Asia.

In the past, the divide was a choice between modernity and backwardness, freedom and tyranny, individualism and collectivism, and capitalism and feudalism, and in the long run, between progress and stagnation. Today, however, the rapidly growing East has actually become a new West.

Some characteristics of NEC

The introduction of new elements into the present competition has made it more complicated; at the same time, the world's evolution less predictable. In the face of new challenges and rifts, the American and European poles of the traditional West, which have diverged after the Cold War, may attempt to achieve a new rapprochement. However, their relative unity would be possible only if systemic military confrontation is restored in one way or another.

The United States will continue relying on NATO to retain its positions in Europe and, possibly, to encourage a new military-political confrontation. There is an unrealistic but consciously provocative plan to transform the North Atlantic Alliance by

including other countries, such as Japan, South Korea, Australia and New Zealand, thus transforming the bloc into a political-military foundation of a global “union of democracies.”

The very idea of establishing a community of powerful and responsible states that could lead the struggle against new threats to world order is quite reasonable. But in the new epoch of an all-against-all competition, such an idea is not only highly unlikely, but also simply harmful, as it may sow the seeds of a new ideological divide and systemic confrontation.

Ivo Daalder and James Lindsay forwarded this very idea late last year in an article published in *The American Interest*. The authors argue, “the world’s democracies possess the greatest capacity to shape global politics. They deploy the greatest and most potent militaries; the largest twenty democracies are responsible for three-quarters of the resources spent on defense in the world today.” Then they ask the question: “Can a Concert of Democracies succeed if it excludes large countries such as China and Russia?” The answer: “Of course it can.” The authors then attempt to allay possible fears that “the creation of a Concert of Democracies might encourage China and Russia to create an alternative organization.”

The momentous changes in the global economy and politics, together with the rapid redistribution of forces and resources, increase the perception of unpredictability of the external environment. This is why the NEC will most likely be marked by the continued remilitarization of international relations, and even an arms race. NATO’s further enlargement will be more likely if Russia takes the bait and starts adding fuel into the fire of global remilitarization.

Bitter multi-level competition – economic, geopolitical and ideological – will become another characteristic of the NEC. Russian Foreign Minister Sergei Lavrov has formulated this peculiarity of the new world in the following way: “The paradigm of contemporary international relations is determined by competition in the broadest interpretation of this notion, particularly when the object of competition is value systems and development models. The novelty of the situation is that the West is losing its monopoly on the globalization processes. This, perhaps, explains attempts to present the current developments as a threat to the West, its values and way of life.”

We may expect to see renewed attempts to limit the economic expansion of the authoritarian capitalist countries and their affiliated corporations. Many liberal states are now borrowing protectionist practices from the newly authoritarian capitalists and introducing limitations on foreign investment in “strategic industries.” Meanwhile, the desire to use antiquated international organizations as instruments in the new competition may undermine their importance. The influence of the International Monetary Fund has drastically diminished; the World Bank is losing its positions; and destructive attempts are being made to use the World Trade Organization in the interests of its founders – countries that are representative of “old” capitalism. It is important to note that the increase of protectionism, in addition to trade and investment conflicts, has often preceded military clashes in the past.

Competition will intensify in the ideological domain, as well, where the democracies have already launched a counterattack. The United States needs to restore

its own attractiveness. Unfortunately, the fierce competition will most likely turn the struggle for lofty democratic values into geopolitical confrontation. This factor may delay the potential for liberalization in those countries that have shown allegiance to authoritarian capitalism, including Russia. One should not forget the Cold War lessons. At that time, strong pressure from abroad strengthened the positions of reactionaries and conservatives inside of the country. Like in the past, those who seek reforms in the country will now be easily labeled as agents of rival states.

The most unattractive consequence of the new multifactor competition will be the lower intensity and quality of international cooperation in countering global challenges, among them the proliferation of weapons of mass destruction, environmental degradation and the growth of Islamic extremism.

The time frame for the NEC is predictable. In five to seven years, Europe will most likely start overcoming its current systemic crisis, and its economic development will accelerate. America will leave Iraq, overcome its “Iraqi syndrome,” and return to a more rational multilateral policy. Russia will come down to earth after its present euphoria and will conduct a more cautious, although not less active, policy.

There will emerge political and economic prerequisites for overcoming the current irrational confrontation over energy supplies, as well as for establishing an Energy Union in Europe.

Energy consumers will probably adapt to the new situation caused by the redistribution of resources from private and foreign ownership into state hands. However, nor can a wave of re-privatization be ruled out, either. History has known many examples when governments, having received the required incomes and witnessing the inefficiency of state-run companies, gave the management of natural resources to private businesses. Some form of partial re-privatization is likely to happen in Russia too.

The ideological foundation of the new confrontation and competition between the two models of capitalism can also be partially overcome, as these models are not as incompatible as “real socialism” and capitalism.

Global challenges, which are currently being countered due to the acute competition of the NEC, will require even closer cooperation. A new round of such cooperation may be more stable than it was in the 1990s. In those years, interaction between states was conducted according to the rules dictated by the victors in the Cold War, which doomed those efforts to failure.

But an epoch of closer cooperation will arrive only if the global community, including Russia, avoids a systemic mistake, that is, structuring and militarizing the new competition. Furthermore, there must be no new military confrontation, which would most likely occur in the Greater Middle East. The evolution of the competition to the point of systemic confrontation may ultimately bring about a series of large wars and even a new world war.

What should Russia do in this situation?

First, Russia's arrogant faith in success, which is quite understandable after years of losses and humiliation, must be given up. All forecasts about the development of the global economy indicate that in the foreseeable future Russia will not be able to rise above the current 2.5 percent of the world GNP; and if we do not achieve a sustainable growth of 8 to 10 percent a year, our share will tend to decrease. In addition, most of the factors that in the past few years predetermined Russia's achievements (these factors range from the general decline of global governability to China's success) may bring about serious problems in the long term.

Second, the new epoch of competition requires the transition to a knowledge economy; advantages based on energy resources are transient. The continuous modernization of the political system is required in order to prevent a slide into stagnant authoritarianism. If Russia does not take avail of the favorable economic and geopolitical situation, and fails to use semi-authoritarian and state-capitalism methods for moving to a new development model, the country's decline in the next epoch will be predetermined.

Third, the world is growing increasingly complicated. Compared to the Soviet Union, Russia's dependence on the outside world has increased dramatically. Therefore, it must sharply increase investment in the study of the current international environment. It must also invest in personnel training so that new specialists could use new methods to protect the positions of Russia and its corporations and to advance their interests.

Fourth, all efforts must be made to prevent the remilitarization and institutionalization of the new competition, which would be disadvantageous in terms of medium and long-term interests. Hence a policy is required for preventing NATO's further expansion and consolidation, while caution must be used when entering into alliances and conducting disarmament negotiations. Previous experience has shown that these may be used for remilitarizing politics.

Countering remilitarization does not mean giving up efforts to rebuild the armed forces on a new basis; nor does it mean that Russia should avoid the modernization of its military doctrine. At the same time, a reasonable restoration of military power must be based on unilaterally identified needs, rather than on even asymmetrical responses to the actions of others.

Fifth, cooperation with all responsible forces is necessary to prevent a further proliferation of nuclear weapons and new large-scale conflicts, especially of a nuclear variety, which can provoke the uncontrolled deterioration of the international political environment.

Sixth, there is no sense for Russia to make concessions to the West during an acute phase of the New Epoch of Confrontation, which would be marked by a fierce counterattack by a losing West. Concessions would be taken as manifestations of weakness. However, Russia should avoid unjustified demonstrations of strength, which Russia will be provoked into and which will only make Russia waste its emerging strength.

Russia is no longer a losing country that is trying to create leeway. Thus, it is important that we must once again smile politely, rather than in a scoffing or arrogant manner.

RUSSIA, THE WEST AND IRAN

BY AMBASSADOR ROBERT D. BLACKWILL

We are witnessing a systemic decline in Russia's relations with the West. There is a long list of complaints from the industrial democracies regarding Moscow's behavior, many of them justified. But the U.S.-Russia relationship (and that of Europe and Russia) does not occur in a strategic vacuum. Many of Russia's contemporary offenses pale before what should be the West's highest policy priority in the period ahead: preventing Iran from acquiring nuclear weapons.

According to a December 3 US National Intelligence Estimate (NIE), it will be difficult to convince Tehran to forgo the eventual development of nuclear weapons and Iran could produce sufficient HEU for a weapon as early as 2010.

This is a function of a centuries-long ambition to acquire the attributes of a great power and to reclaim Persia's ancient position as the hegemon of the region. (As one Middle East leader recently said to me, "Think Darius as well as the Mullahs.") So far, international pressure to persuade or coerce Iran into suspending its enrichment program as required by the UN Security Council has been ineffective. And it appears unlikely that currently discussed UNSC, ad hoc or U.S. unilateral sanctions, which would take years to make a decisive difference, will be strong enough to force Iran to freeze its nuclear enrichment program, especially given that Tehran is now cushioned from the effect of such relatively weak sanctions by an oil price of \$80 a barrel.

If Iran stays on its current pace of development, it could be approaching a point of technical mastery of large-scale enrichment by the end of 2009. This could provide Iran an irrevocable capability to produce nuclear weapons, even if it had not completed weaponization.

Let me be very clear. President Bush and Secretary Rice are deeply committed to trying to solve this problem with Iran through multilateral diplomacy. They understand that multilateralism, which in the past was regarded by some as only a diplomatic alternative for the United States, has now become a compelling foreign policy requirement. They genuinely seek to avoid a binary choice by an American president either to attack Iran or to acquiesce to Iran's possession of nuclear weapons. However, at present there is no evidence that this matter can be successfully resolved, including through unconditional bilateral negotiations with Iran, which I support.

If, despite the West's best efforts, diplomacy fails and the United States attacks Iran's nuclear facilities, Tehran would respond with a variety of countermeasures against the United States and any nation that was seen to be assisting it—both in the region and in the world at large, including probably in the American homeland. This would be a long war, likely lasting for years, since Iran would not surrender. It would inflame the entire Islamic world, strengthen terrorist forces everywhere and, given the projected meteoric rise in oil prices, could well trigger a global recession.

Iranian possession of nuclear weapons would have devastating strategic consequences for the West for decades. This is why a prominent Asian leader and strategist told me recently, "If Iran acquires nuclear weapons, it will change the world" and a Middle East

monarch noted, “If the United States attacks Iran, there will be serious trouble in the region for 18 months. If Iran gets nuclear weapons, there will be serious trouble in the region for thirty years and beyond.” Should Iran go nuclear, how many Sunni Arab regimes would follow suit and who believes that in a Middle East with multiple nuclear-weapons states, we would not eventually have a nuclear catastrophe in that region, in a Western city or both?

If we are to avoid either of these horrific outcomes, Russia will have to play a central and positive role. We are unlikely to succeed without Moscow. It has a closer relationship with Iran than any nation in the West. It has a long-time civil-nuclear relationship with Iran, which gives it unique access to the Iranian nuclear elite. Thus, its potential to importantly affect Tehran’s calculations is probably greater than the combined efforts of Europe and the United States. And, most important, Russia must agree if the Security Council is to adopt punishing economic sanctions that would have the unambiguous force of international law and might alter Iran’s future nuclear choices.

In this context, it is crucial and urgent that the West’s overriding objective vis-à-vis Russia should be to secure its assistance in curtailing Iran’s nuclear options. But to do that, and in the spirit of Metternich’s comment that “the obvious is always least understood”, we need to substantially change our current approach to Moscow. In the first instance, this means that it is time for the West, including the United States, to stop trying to reform Russian domestic politics. In overly emphasizing that subject with Moscow, we are reducing the West’s chances of success in by far the most critical issue before us—preventing an Iranian bomb.

President Putin has obviously moved Russia away from the path toward a Western-style liberal democracy attempted during the Yeltsin era—albeit in a highly flawed and tenuous manner—to the Kremlin’s vision of a strong and centralized “sovereign democracy. Russians have clearly embraced Putin’s course, as evidenced by his authentically high approval ratings of 70–80 percent. Based on a recent poll, one out of three Russians would like to see Putin become president of Russia for life. In short, there is a new sense of dignity and confidence in Russia, and ordinary Russians give Putin the credit as shown in the December elections for the Parliament. Although they were certainly flawed, they did demonstrate that Putin is the most genuinely popular political leader in the G-8.

The West must contend with the impending reality that however Putin chooses to continue to wield power, his economic policies and the highly centralized political structure will remain in place in Russia for the foreseeable future. The Russia we now see is fundamentally the Russia we are going to get. And the Russian elite are not going to accept Western intervention into their domestic affairs until, as they say, “the crayfish whistles on the mountain top.”

However, the West does have significant ability, which we are currently exercising, to sour Russia’s relations with the United States and Europe and to undermine our joint capacity to cooperate with Moscow regarding the Iranian nuclear threat because of our persistent public preoccupation with the shape and substance of Russia’s domestic political practices. We should greatly reduce the frequency and the volume of our public pronouncements on this subject, while privately of course condemning it.

Having said this about the West and Russian domestic politics is not to underrate the difficulties of interacting with Moscow on its external policies and often raw pursuit of power

politics and spheres of influence. Russia's foreign policy under Putin is in the classic 19th-century European mold and seeks to reassert Russia's traditional role as a great power; reestablish its dominant position in the former Soviet sphere; and promote and secure markets for its energy exports which advance its geopolitical and geoeconomic objectives.

In this circumstance and unlike during the Yeltsin era, Putin's Russia perceives Western influence in neighboring states as a direct threat to its abiding vital national interests, as evidenced by its harsh reaction toward the alleged role of the West in "orchestrating" the Rose Revolution in Georgia in 2003 and the Orange Revolution in Ukraine in 2004 as well as continuing Western interest in both those countries, including possible NATO membership.

Russia is vehemently opposed to American plans to install U.S. missile-defense systems in Poland and the Czech Republic. Although I do not agree, the Russian establishment perceives these U.S. systems in Eastern Europe as a direct threat to Russian national security. Russia has clashed repeatedly with the United States and the EU over the independence of Kosovo.

Russia and the West differ on the future of the Conventional Armed Forces in Europe Treaty (CFE). We have disagreements with Russia within the OSCE on the proper role of election observers in the former Soviet space. We have arguments with Moscow on the post-START and post-Treaty of Moscow regime. We oppose Russian arms sales to Syria and Iran. We have disputes with the Putin government regarding Russia's external energy policy and its sometimes coercive character regarding its neighbors. We haggle over the final terms of Russia's entry into the WTO.

Most of these substantive differences between Moscow and Western governments shrink in centrality when compared to the short- and long-term costs that the West would incur through a war with Iran or Tehran's possession of a nuclear arsenal. And therein lays our current core problem: Persuading Russia to cooperate fully regarding Iran. Do we in the West really believe that we can acquire Russian cooperation on issues that matter most to us, while ignoring issues that matter most to them? As Winston Churchill once emphasized (and current Western leaders could usefully take note), "However beautiful the strategy, you should occasionally look at the results."

Let me stress here that I am not suggesting that the West give Russia a free hand in neo-imperialist instincts that Moscow might have in the former Soviet sphere and beyond. But there are strategic priorities, tactical trade-offs and creative compromises possible here that need to be considered by Western governments. Cannot the West adopt flexibility and moderate compromise on at least some of these disputatious issues presently with Moscow: the timeline of U.S. ABM deployments to Eastern Europe; the issue of entry of new NATO members from the ex-Soviet space; the status of Kosovo; the contours of the CFE Treaty; the future of strategic-arms control; Russia's entry into the WTO and so forth?

Any of these moves on the West's part would not be offered up unilaterally with the hope that Russian policy toward Iran would inevitably and fundamentally toughen. Rather, they would be explicitly linked to a Russian approach to Tehran in step with Western strategy. This is particularly urgent because Russia and the West currently differ so significantly on the issue.

This past October, Russian Foreign Minister Sergei Lavrov told his Japanese counterpart that "North Korea poses a fundamental threat, but Iran does not." When he met

with French President Nicolas Sarkozy on October 10, Putin stated: “We don’t have information showing that Iran is striving to produce nuclear weapons. That’s why we’re proceeding on the basis that Iran does not have such plans.” When asked about whether Russia would support tightening economic sanctions on Iran, in the aftermath of the announcement of new unilateral U.S. sanctions, Putin replied, “Why worsen the situation by threatening sanctions and bring it to a dead end?”

Nevertheless, the Kremlin agrees that a nuclear Tehran would be a real danger. After meeting with Sarkozy, Putin conceded that not only is a nuclear-armed Iran not in Russia’s interest, but opined that it would pose a greater threat to Russian national security than to European or U.S. vital national interests.

So it is up to the West to convince Russia that, regarding Iranian nuclear ambitions, Moscow’s long-term equities are best served by comprehensive and full-fledged cooperation with the West. But we only have a chance of doing that if we substantially narrow our policy differences with Russia on many of these other matters. In the end, this strategy might not work. Moscow may currently be too defiant to collaborate with the West. It may decide that its long-term relationship with Iran trumps Western nuclear preoccupations. Putin and company may conclude that it is inevitable that Iran will acquire nuclear weapons and that joining Washington and its allies in a self-defeating enterprise makes no sense. Moscow may wonder if the next American president will follow the same muscular policies regarding Iran as the current one. So such a Western initiative could well fail. But given the stakes involved, it is worth a try. The new NIE has given us somewhat more time to avoid a war with Iran. We should use it, including in Moscow.

Robert D. Blackwill, a member of the Trilateral Commission, is President of Barbour, Griffith and Rogers International, a Washington government affairs, consulting and lobbying firm. He was the deputy national security advisor for strategic planning and the U.S. ambassador to India, 2001–2004.

RUSSIA'S EUROPE

BY IVAN KRASTEV

Post-Cold war Europe is history. The Kremlin's decision to suspend the Treaty on Conventional Forces marked the end of the post-modern European order. The new reality is the re-emergence of Russia as a great revisionist power in the old continent. And so Russia's "decade of humiliation" is over. Her "still terrible thirst for greatness" is back. The question is: what does Russia really want? Is Russia a neo-imperial power aiming to dominate her weaker neighbors, or is she a post-imperial state trying to defend her legitimate interests? Does Moscow view the European Union as a strategic partner in shaping the new European order or does it view it as a threat to Russia's ambitions in Europe? How stable is Putin's regime, what are the Kremlin's long-term interests and short-term fears? What should the response of the West be?

Putin's Russia scares because she confuses. Russia is a rising global power while also a *sui generis* weak state with corrupt and inefficient institutions. Putin's Russia is more democratic – but less predictable or reliable – than the Soviet Union. Putin's regime seems rock-solid and extremely vulnerable at the same time. Russia's economic growth looks both impressive and unsustainable. Russia's foreign policy is a puzzle. The more capitalist and Westernized Russia becomes the more anti-Western her policies are.

The Rise of a Declining Power

Russia's resurgence comes at a time when the United States' global hegemony is declining and Washington is desperately seeking allies and opportunities to preserve the country's global predominance, while the European Union is undergoing a profound crisis of its global relevance. The promise of international order where nations grow together or disappear altogether, where ideological conflicts have melted away and where cultures have intermingled through increasingly free commerce and communications has turned out to be a mirage. „The world has become normal again... Struggles for honor and status and influence in the world have once again become key features of the international scene.” So, the question is: how serious is in fact the Russian challenge and what are the sources of the current crisis in the relations between Russia and the West? Is Russia a rising power, or is she a declining power enjoying a temporary comeback?

The soaring prices of gas and oil have made energy-rich Russia more powerful, less cooperative and more arrogant. Oil money has boosted the state budget and has dramatically decreased Russian state dependence on foreign funding. Russia's hard currency reserves are the third largest in the world today; the country is running a huge current account surplus and paying off the last of the debts accumulated in the early 1990s. Russia's reliance on Western credits has turned into Europe's reliance on Russian energy resources. Russia's military budget has increased six-fold since the turn of the century and Russia's intelligence network has penetrated all corners of Europe. Moscow succeeded in re-gaining effective control over the entire territory of the Federation. Chechnya is 'pacified' – at least for the time being – and President Vladimir Putin enjoys the support of more than 80 percent of Russian citizens. Russia's influence in global politics has increased dramatically as well. Russia has managed to re-gain a strategic hold in Central Asia. Putin invested a lot of energy and political skills in making the Shanghai Cooperation Organization appear a credible counter-balance to the

hegemony of the West in the region. The UN Security Council deadlock on the status of Kosovo is the latest demonstration of the new reality – Russia cannot be ignored any more.

In short, Russia is a rising power that does not want to be lectured any more. She wants to lecture. The West is no longer in the position to ask “what to do with Russia”. The question now is “what to do about Russia”.

At the same time, Russia remains a highly vulnerable power. Her economic growth is mostly the outcome of rising energy prices and overall levels of technological modernization are still very low. Energy exports finance about 30 percent of the Kremlin’s budget. Russia’s is a classical oil regime rife with corruption and inefficiency. Ongoing underinvestment in the development of new oil and gas fields threatens the prospects for further increase of energy exports and signals future shortages on the domestic market. Standards of living have increased but Russia still is a poor country. Social inequality is skyrocketing, education continues to deteriorate. There is not a single Russian university among the world’s top 50 universities. Alcoholism and a collapsing health system have been fueling a demographic catastrophe: the population has been shrinking by 700,000 annually for the past eight years despite the fact that the country’s HIV/AIDS epidemic has not yet peaked. Male life expectancy is among the lowest in the world. Regardless of its recent foreign policy initiatives Russia remains quite isolated in global politics. In the long term, Russia is more threatened than heartened by the rise of China and India. She is extremely vulnerable to the rise of radical Islam. A recent global poll indicates that – unlike China’s – Russia’s global influence has not recovered since the collapse of the Soviet Union; while in Europe Russia is back center- stage, European public opinion in the last two years has become more skeptical and even hostile to Russia’s policies and to the charms of President Putin and his regime.¹ In short, Russia is a declining power blinded by a contemporary comeback.

Lost in the labyrinth of Russia’s unexpected revival, Western policy makers have been agonizing between their desires to “speak tough” and “teach Russia a lesson” and the realization of the fact that the West has lost its way pretending that it has a carrot as big as a stick. Policy slogans such as “contain Russia” or “engage Russia” best illustrate the poverty of the debate. The West has increasingly been analyzing Russia as a geopolitical and economic player while paying decreasing attention to the nature of its regime and to the link between the country’s foreign policy and its domestic politics. Criticizing Putin’s regime is not a substitute for understanding it. The main weakness of the West’s Russia policy is the astonishing lack of interest in the nature of Putin’s regime.

The Nature of Putin’s Regime

Putin's Russia is not a trivial authoritarian state. It is not "Soviet Union lite" regardless of the fact that the music of Russia’s new national anthem is the old Soviet one. It is not a transition democracy either. It is not a "managed democracy" or “over-managed democracy”. The term captures the logic and the mechanisms of the reproduction of power and the way democratic institutions are used and misused to preserve the monopoly of power. But the concept of managed democracy cannot illuminate Putin's Russia when considered not as a power machine but as a political project. It cannot explain why Putin has resisted becoming president-for-life like his central Asian peers thus risking the stability of the entire political construction that he has built. The notion of “managed democracy” is also useless in predicting how stable the regime is. What strikes the observer of the political processes in today’s Russia is the stability-fragility dialectics of the current status quo. Putin’s project

seems to be without alternative. The opposition is marginal and marginalized – lacking in ideas, leaders and public support. At the same time, Moscow’s elites are extremely nervous and insecure. The “succession” has paralyzed their imagination. Why are the elites so scared if the regime is so stable?

The mystique of the “succession dilemma” fascinates any analyst of today’s Russia. If Putin wants to keep the European identity of his regime and cares about the long-term stability of the country he should step down after the end of his second constitutional term, as previously announced. But if he wants to prevent short-term destabilization of the regime he should either stay President for life or he should take residence on the moon. The possible co-existence between the ex-President Putin – the founder of the regime – and his handpicked successor is a mortal danger directed at the heart of the Russian political system. It was none other than the Kremlin’s ideologue-in-chief Vladislav Surkov who concluded that the key elements of the current regime and Russia’s political culture in general are the centralization of state power, non-pragmatic (utopian) legitimizing of the political system, and the personification of power institutions. The truth is that Putin’s Russia cannot survive the cohabitation between the people’s President and the constitutional President.

What is missing in Western attempts to make sense of Putin's Russia is an insight into the political imagination of the current political elite in Moscow. Also missing is an interest in the arguments used by the regime to claim legitimacy. Putin's critics inside and outside Russia are inclined to dismiss the intellectual substance of the Kremlin-promoted concept of "sovereign democracy". In their view "sovereign democracy" has only propaganda value. Its only function is to protect the regime from the criticism of the West. The assumption is that cynicism and the naked will to stay in power and be rich is the Kremlin’s only ideology. But is this really the case?

What the West has failed to notice is the explosive mixture of mercantilism and messianism in the Kremlin’s foreign policy.

In our view the concept of “sovereign democracy” synthesized in Kremlin’s ideological laboratory can be the key to understanding the ambitions, fears and constraints of Putin’s regime. The concept of sovereign democracy succeeds in confronting Kremlin's two ideological enemies of choice: the liberal democracy of the west and the populist democracy admired by the rest. It pretends to reconcile Russia’s urgent need of Western-type modernization and Russia’s will to defend its independence from the West. It is the logic of the sovereign democracy more than the rivaling interests or unshared values that are the source of the growing tensions between Russia and the European Union.

"Sovereign Democracy": the Political Origin

By nationality the concept of sovereign democracy is Ukrainian. It has its origin in the Kremlin's conceptualisation of the orange revolution (“orange technologies”, in Kremlin terms) of November 2004 to January 2005 in Ukraine. The impact of the Ukrainian orange revolution on Russian political thinking can be compared only to the impact of 9/11 on the American political imagination. Sovereign democracy is Moscow's response to the dangerous combination of populist pressure from below and international pressure from above that destroyed the Leonid Kuchma regime. The Kyiv (Kiev) events embodied the ultimate threat: a remotely controlled popular revolt. Putin's preventive counter-revolution that followed marked a “regime change” in Russia. In the regime of "directed democracy" that

Putin inherited from Boris Yeltsin, elites deployed such institutional elements of democracy as political parties, elections, and diverse media for the sole purpose of helping those in power stay in power. Elections were held regularly; they did not provide an opportunity to transfer power, but only to legitimise it. The "directed democracy" of the 1990s, in contrast to the classical models of managed democracy, did not imply a ruling party to manage the political process. The key to the system was the creation of a parallel political reality. The goal was not just to establish a monopoly on power but to monopolise the competition for it. The key element in the model of directed democracy was that the sources of the regime's legitimacy lay in the West. The project of faking democracy assumes that the faker accepts the superiority of the model he fakes. Being lectured by the West was the price that the Russian elite paid for using the resources of the West to preserve its power.

In its social origins, directed democracy reflected the strange relations between the rulers and the ruled in Yeltsin's Russia. Stephen Holmes has acutely portrayed this relationship: "Those at the top neither exploit nor oppress those at the bottom. They do not even govern them; they simply ignore them." Directed democracy was a political regime that liberates the elites from the necessity of governing and gives them time to take care of their personal business. It was perceived as the best instrument for avoiding a bloody revolution; at the same time, it created room for the "criminal revolution" that transferred much of the nation's wealth into the hands of a few powerful insiders. It was the most suitable regime for a "non-taxing state". There were taxes in Russia, but nobody really cared to collect them; there were elections, but they were not allowed to represent real interests. Post-communist elites discovered the irresistible charm of state weakness. Russia was a weak state, but it was also a cunning state, one that was quite selective in its weakness. It failed to pay the salaries of workers, but was strong enough to redistribute property and even to repay foreign debts when this was in the interest of the elites. The regime's strategy was to keep up the illusion of political representation while at the same time preventing the interests and sentiments of the transition's losers from being represented. The model of directed democracy made the elites independent of the citizens' legitimate claims. None of the reforms implemented in Russia in the heyday of directed democracy was initiated by pressure from below. It is this total disregard for the basic needs of the people that constitutes the most vulnerable spot of Russia's system. "The political technologist" was the ultimate regime-maker.ⁱⁱ

In the current Western discourse on Russia, Putin's authoritarianism is usually contrasted with the imperfect democracy of Yeltsin's Russia in the way that tyranny contrasts with freedom. In reality, Yeltsin's liberalism and Putin's sovereigntism represent two distinctive but related forms of non-representative political systems. What they differ on is the perceived role of the state in public life and the sources of legitimacy of the two regimes. Another difference is the price of oil. Yeltsin's regime was busy to dismantle the public's expectations towards the state. Putin's regime, born out of soaring energy prices and the urgent need to prevent the total collapse of the social infrastructure was determined to re-connect the prosperity of the elites with the glory of the state. Yeltsin's "faking of democracy" was replaced by Putin's consolidation of state power through nationalization of the elite and the elimination or marginalisation of what Vladislav Surkov calls "off-shore aristocracy" – Berezovsky, Gusinsky et al. The nationalization of the elite took the form of a *de facto* nationalisation of the energy sector, total control of the media, *de facto* criminalisation of Western-funded NGOs, Kremlin-sponsored party-building, criminal persecution of Kremlin's opponents (the case of Mikhail Khodorkovsky) and the creation of structures that can secure active support for the regime in a time of crisis (such as the *Nashi* [Ours] movement). The newly adopted anti-extremism legislation *de facto* opens any opposition activity to potential criminalization.

The offshore oligarchs were replaced by state serving oligarchs. Asked by reporters what he will do if the Kremlin asks him to turn all his assets over to the state the biggest Russian oligarch Oleg Deripaska wisely declared that he will not disappoint the Kremlin. This transformation explains one of the puzzles of present-day Russia – the form of property – private or public – does not matter when it comes to big Russian companies. They all are state-minded companies and their economic policies are a better reflection of the priorities of the Russian state than of existing market opportunities. In Russia the communist one-party state was replaced by Putin’s one-pipeline state.

Contrary to the Western accusation, the Kremlin (populated by many non-Russians) did not base its regime-building project on the mobilization of Russian ethnic nationalism. The relationship between Russian ethnic nationalism and the Kremlin’s notion of sovereign democracy is much more ambiguous and complex than Putin’s critics assume. The Kremlin uses traditional Russian nationalism when it needs to but basically the Kremlin is in the business of controlling and not mobilizing it. While the government is quite “theatrical” in repressing its liberal and pro-Western opponents (mainly to show the West that it will not tolerate interference in its domestic politics) the Kremlin is efficient and ruthless in repressing the nationalists. Sovereign democracy in the Kremlin’s view is the Russian version of European civic nationalism. Natural resources, remembering the Soviet victory in the World War II and the promise of sovereignty are the pillars of the project. Russia’s transition from empire to nation state has found a logical end in the concept of “sovereign democracy”.

In the view of the Kremlin, sovereignty is not a right; its meaning is not a seat in the United Nations. For the Kremlin, sovereignty is a capacity. It implies economic independence, military strength and cultural identity. In the Kremlin’s vocabulary, Sovereign power is a synonym for Great power. A key element of the sovereign state is a “nationally-minded” elite. The nature of the elite in the view of the Kremlin’s ideologues is the critical component of the sovereign state. The creation of a nationally-minded elite is the primarily task of sovereign democracy as a project. Moreover, the need for a nationally-minded elite requires a nationally-minded democratic theory. Putin’s Kremlin never viewed Central Europe’s new democracies as a model for the political development of Russia because in Moscow’s view the small states of Central Europe have never had the capacity to be sovereign. They are doomed to gravitate around some of the sovereign poles of power. In this context Moscow is ready to acknowledge that membership in the European Union was a real opportunity for small countries like Bulgaria or Poland but it cannot be an option for post-imperial Russia.

Sovereign Democracy: the Intellectual Origin

What is really fascinating in the concept of sovereign democracy is not the regime it tries to legitimize but the intellectual framework for its justification. Over the past two decades, Russia's market of ideas has never been short of theories arguing the uniqueness of the country’s culture and history, or of reflections on Russia's mission in the world. There were many voices insisting that Russia should break its ideological dependence on Western theories. What is telling is that the ideologues of sovereign democracy are not interested in the various "Russian uniqueness" theories in building their project. The Kremlin's revolt against the Anglo-Saxon theory of liberal democracy centered on individual rights, and the system of checks and balances, is not rooted either in criticism of democracy as a form of government or in theories of Russia's exceptionalism. In constructing the intellectual justification of the model of sovereign democracy, the Kremlin's ideologues turned to the intellectual legacy of

continental Europe – the French political rationalism of Francois Guizot and Carl Schmitt's "decisionism".

Guizot and Schmitt surprisingly emerge as the intellectual pillars of the Kremlin's idea of sovereign democracy. What attracts Surkov and his lieutenants to the legacies of Guizot and Schmitt is obviously their anti-revolutionism and their fundamental mistrust towards the two concepts of the present democratic age – the idea of representation as the expression of the pluralist nature of the modern society and the idea of popular sovereignty that defines democracy as the rule of the popular will. Anti-populism and anti-pluralism are the two distinctive features of the current regime in Moscow. Following Schmitt (1888-1985), the theorists of sovereign democracy prefer to define democracy as "identity of the governors and the governed"ⁱⁱⁱ. And, following Guizot, the sovereign for them is not the people or the voters but the reason embodied in the consensus of the responsible national elites. In the Kremlin-made mixture of Guizot's anti-populism and Schmitt's anti-liberalism elections serve not as an instrument for expressing different and conflicting interests but in demonstrating the identity of the governors and the governed; not a mechanism for representing people but one for representing power before the people.

What is at the heart of Putin's regime is governmentalization of the state. The Kremlin thinks not in the terms of citizens' rights but in the terms of the population's needs. The concept of population is contrasted both to the notion of rights at the core of the liberal democratic project and the notion of "the people" that is at the core of nationalist projects. The rights of the citizen-voter that are the foundation of liberal democracy have, in Putin's Russia, been substituted by the rights of the consumer, tourist and Russian soul-owner. What Surkov and company have realized is that the idea of sovereignty has influence that is more universal than that of democracy. Even the most undemocratic of the modern regimes must claim its legitimacy not from the divine right or dynastic succession or the right of conquest but from the will of the people, however expressed.

Schmitt's definition of the sovereign as "he who decides on a state of exception" perfectly fits the almost metaphysical role of the figure of the president in the Russian political system today. Schmitt's definition of democracy in terms of identity and not in terms of representation does not allow a meaningful distinction between democracy and dictatorship. And this could also count as an advantage in the eyes of the Kremlin's theorists of democracy.

Contrary to the assertions of Putin's critics, the concept of sovereign democracy does not mark Russia's break with European tradition. It embodies Russia's ideological ambition to be "the other Europe" – an alternative to the European Union. The Kremlin has developed an ideological project that is not only attractive for many in post-Soviet Europe but a project that existentially challenges the European Union. What is at stake in the current tensions between Russia and the European Union is the nature of the post-post-Cold war European order and the cultural and political identity of European states.

Russia as the Other Europe

"Russia is very old Europe," wrote Carnegie analyst Dmitri Trenin, "it could be reminiscent of Germany in the 1920s, with its vibrancy and intense feeling of unfair treatment by others; France in the 1940s, when it was trying to heal its traumas; or Italy in the 1960s, as far as the nexus of power, money, and crime is concerned"^{iv}. Russia is indeed very old Europe. It

embodies the nostalgia for the old European nation-state and nostalgia for a European order organized around the balance of power and non-interference in the domestic affairs of other states.

Russia's view of the European order is a mixture of nostalgia for the time of the "concert of Europe" and envy of present-day China, that is managing to balance opening to the West with rejection of any Western interference in its domestic politics. For the Kremlin the end of the Cold war meant a return to the pre-Cold war European order. For Western Europe the end of the Cold war meant the rise of the post-modern European state. While the European Union dreams of cosmopolitan democracy, Russia dreams of the Congress of Vienna.

"What came to an end in 1989," wrote Robert Cooper, summarizing Europe's consensus, "was not just the Cold War or even, the Second World War. What came to an end in Europe (but perhaps only in Europe) were the political systems of three centuries: the balance of power and the imperial urge"^v.

The European policy elite assumed that the end of the Cold War meant the emergence of a new European order. The key elements of this post-modern European order are a highly developed system of mutual interference in each other's domestic affairs and security based on openness and transparency. The post-modern system does not rely on balance of power; nor does it emphasize sovereignty or the separation of domestic and foreign affairs. It rejects the use of force as an instrument for settling conflicts and promotes deliberately increasing mutual dependence and vulnerabilities between European states. The essence of the post-modern order was the gradual transformation of the traditional European nation state into an EU member state. The post-communist countries of Central Europe are the best examples of the success of the EU's member-state building project.

Russia of the 1990s was not a post-modern state but it was part of the post-modern European order. Yeltsin's faking of democracy was also a faking of post-modernity. The Treaty on Conventional Forces in Europe and the OSCE (based on intrusive inspections and active monitoring) were the major instruments for integrating Russia in the post-modern system. They made Russia look like a modern state that has accepted the post-modern imperatives of openness and interdependence while suffering from dysfunctionality. Russia's weakness created the illusion that Moscow ideologically subscribed to this system. The reality turned out to be very different. As soon as it had a choice, Moscow chose to build its statehood according to the European practices and ideologies of the 19th century rather than the European ideas of the 21st century. Russia enjoys a world in which Kremlin-friendly oligarchs own English football clubs and the Russian middle class travels freely all over Europe, but at the same time the Kremlin insists that international companies will not be allowed to exploit Russian natural resources and that the Kremlin's domestic critics be expelled from European capitals.

The rhetoric of the EU-Russia cooperation and partnership cannot mask the fact that the regime of sovereign democracy is absolutely incompatible with post-modern hegemony. Russia's decision to suspend participation in the Treaty on Conventional Forces and Moscow's deliberate efforts to block the work of the OSCE marked the end of the post-cold war order in Europe. It is the clash between the logic of the postmodern state embodied in the EU and the logic of sovereign democracy that is at the heart of the current tensions between Moscow and the EU. While the European Union came as a response to the perils of nationalism and the catastrophic rivalries among European nation states in the first half of the

20th century, Russia's foreign policy thinking is shaped by the perils of the post-national politics and the disintegration of the Soviet Union. European nightmares are rooted in the experience of the 1930s. Russia's nightmares are shaped by the Russian experience in the 1990s.

Russia's political elites regard the European Union as a temporary phenomenon, an interesting experiment with no future. Russia's European strategy is based on the expectation that sovereign nation-states will determine Europe's future. This explains Moscow's stress on bi-lateral relations with big European member states (the sovereign states) and its growing reluctance to deal with the European Union. The European illusion from some years ago that Russia can be a European Union partner in the struggle for a multi-polar world society based on international law is dead. For Moscow, support of multilateralism and advocacy of a multi-polar world are simply tactical weapons to contest American hegemony. In reality, Russia's foreign policy instincts are more American than European. Russia believes in power, unilateralism and the unrestrained pursuit of national interest.

In this context the real source of the confrontation between Russia and the European Union today is not primarily rival interests or unshared values. It is political incompatibility. Russia's challenge to the European Union cannot be reduced to the issue of energy dependency and Moscow's ambition to dominate her "near abroad" that happens to be the European Union's "new neighborhood". At the heart of the current crisis is not the clash between democracy and authoritarianism (history demonstrates that democratic and authoritarian states can easily co-operate) but the clash between the post-modern state embodied by the EU and the traditional modern states embodied by Russia.

The controversies around the Energy Charter, the Treaty on Conventional Arm Forces and the Anglo-Russian test of nerves over the Litvinenko murder case are not manifestations of Cold War nostalgia. They are the expression of the different logic of the modern and post-modern states. Much like the European Union, with its emphasis on human rights and openness, threatens the Kremlin's "sovereign democracy" project, so Russia's insistence on balance of power as the foundation of the new European order threatens the very existence of the European Union as a political formation built around the idea of "shared sovereignties". Russia's European policies stimulate the re-nationalization of the foreign policy of the member states (be it Germany or Poland). The EU policy of democracy promotion awakes in Moscow the nightmare of ethnic and religious politics and the threat of disintegration of the Russian Federation. Faced with the invasion of Russian state-minded companies, EU member states are tempted to ring-fence certain sectors of their economies such as domestic energy markets, thus threatening the liberal economic order that is at the center of the European project. Faced with the invasion of Western-funded NGOs, Russia is tempted to re-create the police state.

The contrasting nature of the political elites in Russia and Europe today is one more reason for concern over the future of the relationship. Unlike the defunct Soviet elites who were bureaucratic, risk-averse and competent when it came to international relations and security policies, the new Russian elite consists of the winners of the zero-sum games of the transition. They are highly self-confident, risk prone and immensely wealthy. Europe does not know how to deal with these people. European political elites that made their careers in practicing compromise and avoiding conflicts are facing elites that are proud of not taking hostages. It is not an accident that the Russian word "siloviki", like the words "sputnik" and "perestroika", is one of the few Russian words that do not need translation in any European language.

In short, the clash between Russia and the EU is a manifestation of the political incompatibility of the post-modern state and modern state in the context of the new European order in making. For the post-modern state, “sovereignty is a seat at the table”. For Russia, sovereignty is the right of the government to do what it wants on its territory and to eliminate its enemies in downtown London. Moscow feels encouraged by the resurgence of nationalism and sovereignty in some EU member states and expects the European Union to pass into history just as the Soviet Union did in the early 1990s. Turkey’s recent turn to an Islamic version of “sovereign democracy” (albeit much more democratic than the Russian one) and the European Union’s enlargement fatigue have made the Kremlin believe that “the post-modern moment” in Europe is over. Post-Soviet Russia does not share Europe’s enthusiasm for post-national politics.

The European Union, on the other hand (as an old fashioned social democrat) is convinced in the historical superiority of its political model. In Brussels’ view, Russia’s “sovereign non-democracy” is a transitory phenomenon, a desperate attempt to cheat history. The opening up of the Russian state in Europe’s eyes is just a matter of time. Putin’s regime runs against the very logic of globalization and cannot be sustained. In the early 20th century Communist Moscow challenged European nation states pretending that it represents Europe’s glorious future. In the early 21st century Russia challenges Europe pretending to represent Europe’s glorious past. Europe’s policy to bring Russia to agree to its principles of conducting foreign relations will be interpreted as “double standards” and an attempt for “regime change”. Russia’s policies of unrestrained pursuit of national interests and legal revisionism will be interpreted in Europe as politics of blackmail and manifestation of Russian traditional imperialism. In short, the co-existence between European post-modernity and Russia’s sovereign democracy could become more difficult and dangerous than the co-existence between Soviet communism and Western democracies.

(September 2007)

SESSION ON FUTURE PROSPECTS FOR THE WEST BALKANS AND/IN THE EU

SUMMARY

Kosovo² is putting the EU at a test. The on-going negotiations, led by the EU/US/Russia so-called “Troika”, are heading to their sunset clause on December 10th. What will happen next?

Kosovars are adamant about declaring themselves independent. They are tired of some 18 years of negotiations, and feel ready to become, in the near future, a full-fledged member state of the EU, which means that they should be recognised as a state of their own in the first place.

Everybody acknowledges that **the *de facto* autonomy of Kosovo is a fact**, and taking that ultimate step might look as a natural spillover from what is already part of history. Yet, it entails **two major drawbacks** : the Kosovar Serbs, north of the bridge in Mitroviça, would never accept to be cut off from mainland Serbia, and might in turn run for independence; moreover, the Republika Srepska, in Bosnia, is just expecting such a hint to claim its own right to independence from the Bosnian Federation. This is a first major difficulty, as nobody **is open to furthering the process of partition** that far, let alone the fact that it would jeopardize two decades of very difficult peace-building across the whole region, and challenge the international community, EU in the first place, in a very damaging manner.

The other deadlock comes from the Serb side: **the people in Serbia are not ready to trade the EU membership against chopping Kosovo off their fatherland.** Moreover, they feel that the Kosovo case is offering them **an unexpected leverage to win back most of the power and influence they have lost fighting a lost war**, as the West is mired by its own values and commitments in driving Kosovo to independence at almost any price.

Russia has seen the point, and takes advantage of that uneasy situation of the West, to play checkers and lock the West into a no-way-out position, by vetoing any Kosovar

² KOSOVO DECLARED ITS INDEPENDENCE ON 17TH FEBRUARY 2008

independence. And this is lifting the issue much higher up, as it turns the merely practical problem that the EU could solve, as a player ready to become a big payer, into **a geopolitical deadlock between the West as a whole and Russia.**

As a result, **the Kosovar issue is blocked**, and doomed to remain as a rotten apple in Europe's basket, contaminating everything else. Since any sudden move is banned as a very dangerous triggering of at least another cold war, or a deadly shock to the fragile European external policy, **the issue has to remain frozen**, which is driving the Kosovars mad, and keeps the Serbs beefing up again.

This is by no means of any good for the parties themselves, for the region as a whole, for Europe, and for international relations altogether. **One has to jump out of the pitch one way or the other.**

Many voices are urging Europe to come into play and do what it can best achieve, namely to change societies and, as a result, mentalities, by spreading prosperity, freedom, trade, by opening up people to one another. **This is within reach**, provided that a large majority of the 27 countries agrees on that duty and its compelling emergency. And this will only be possible if **leadership is displayed, involving all major European states** ; Germany could play that role, but the process to do so is neither a straightforward one, nor an easy one, on both internal and European levels.

It would also take **reaching a global agreement with Russia**, as this country is enjoying the winning pattern in this game, and **it would need Europe to design a grand vision and roadmap for the region as a whole**, so that all players find decisive reasons to play by the rule and move in the same direction, high above petty aftermaths of past situations³.

Is such a big deal within sight ? **Not for the moment ; yet time is pressing.** Unless such ambitious solutions are found and unfurled, times will get more difficult for the region. Economies and societies over there may well look better off, enjoying good growth rates, and getting sucked into mainstream international (mainly Western) economic flows, the mortgage

³ This is part of the agenda of the Slovene Presidency of the EU starting on January 1st, 2008.

that Russia is putting, through Serbia and Kosovo, on Europe in the first place, and on the West at large altogether, has nonetheless to be lifted, otherwise the west Balkans will remain a source of weakness, to say the least, in the very bosom of the EU.

It is a matter of credibility for the EU as such, far beyond the specific challenge posed by the future of that fairly small community. **It therefore challenges the future of the EU itself**, even if the EU is not going to fall apart on Kosovo, if the Serbs are not likely to actually implement their dreams of shifting priorities and sailing away from any EU future membership, and if the third World War is not about to break out to please the people of Mitroviça.

The deadline of December 10th is not the end of history. The issue is all about political will and diplomatic wisdom, not about timeframes. All players might keep playing on the cutting edge, short of taking irreparable steps, as the present situation allows all of them to enjoy the kind of benefits they actually place first. **The only player, which is doomed to undergo major losses from such a situation dragging on, is the EU as such.**

SETTING THE BALKANS SCENE

BY TIM JUDAH

Balkan Correspondent, *The Economist*, London

Germany led the way in recognising Croatia in December 1991 and for years was dogged by accusations that it had wrongly forced its European partners to do the same because, argued some, the move was premature. The Croats however celebrated and a song popular at the time was “Danke Deutschland”. Exactly sixteen years later we are again at a Balkan crossroads. Germany is once more at the centre of an uncomfortable diplomatic debate, while now the Serbs are all but singing: “Thank you Russia!”

The purpose of this paper is to provide an overview of the Balkan situation. However it is clear that the issue of Kosovo must be central and predominant. It cannot be separated from the future of Serbia, which of course connects to the future of Bosnia. But, even more importantly, the question of Kosovo relates to far bigger issues than the size of this modest territory of some 2m people might suggest. Namely, the emergence, or not, of a common European foreign policy and the question as to what extent Russia should have a say on issues in the heart of Europe, indeed in an enclave at the heart of the EU.

A year ago the future of Kosovo seemed fairly clear. Since its some 90% Albanian population has long demanded independence, western diplomats predicted and planned for the following: Firstly that Martti Ahtisaari, the former Finnish president, who was presiding over desultory talks for the UN between the Kosovars and the Serbs would produce a document suggesting “supervised independence”. Secondly that the Russians would, despite their reservations, not block the endorsement of this plan at the Security Council and thirdly that this would be done by last Christmas. One hundred and twenty days later the UN mission in Kosovo would leave and hand over to a major ESDP mission, supervising police and justice, while a new body, the International Civilian Office (ICO) would be created. The head of this would then act as a kind of powerful international governor general, in exactly the same way as the High Representative has in Bosnia.

All the best-laid plans in the Balkans go astray. Now, almost a year later none of the above has happened. Serbia’s leadership first asked for, and got, a delay in the presentation of the Ahtisaari plan because they were holding, first a referendum on a new constitution, which highlighted Kosovo’s place in Serbia, and then general elections. Mr Ahtisaari’s plan was finally presented to the Security Council in March. There, after weeks of discussion and the drafting of several resolutions, the process was finally abandoned. It became clear that when the Russians threatened to veto a resolution which would, in one way or another, lead to Kosovo’s independence, they really meant it.

Why were, and are, the Russians so firm in opposing the self-determination of the Kosovo Albanians? There is no one single reason. Firstly there is the human factor. Many of the men making foreign policy, prime amongst them foreign minister Sergei Lavrov, were also important figures in 1999, (Lavrov was the Russian ambassador to the UN,) and felt personally humiliated by their inability then to prevent NATO bombing the Serbs for 78 days. Revenge is a dish best served cold and in this case the dish is Kosovo. Secondly, however

much western diplomats like to protest that the independence of Kosovo would not be a precedent for anywhere else, this is widely disbelieved. What is the difference for example, apart for the geopolitical situation, between Kosovo and Iraqi Kurdistan? Russia is surrounded by a number of secessionist territories and of course there is the issue of Chechnya, albeit quiet at the moment. The territories are in question are Nagorno-Karabakh, South Ossetia, Abkhazia and Transnistria. Simply put, it suits Russia not to have a precedent in Kosovo. And of course this is understandable. Yes, they support secessionists in Abkhazia, in Georgia, but so far, only up to a point. Politically speaking a threshold will be crossed with the independence of the first sub-republican unit of one of the former communist federations.

The third main reason for Russian opposition to Kosovo's independence is, of course, that Russia "is back". And so, it suits the Russians to use the issue as another tool to emphasise this fact and to divide the EU and to help stymie the emergence of a strong common foreign policy.

So, where are we today? In the wake of the failure of the US and western countries to get the Ahtisaari plan through the Security Council a new so-called negotiating process has been set up. Under the aegis of one ambassador each from the US, the EU and Russia, the three have shuttled about and organised a meeting between the parties in New York on September 28 with another one scheduled for October 10. Barring some unforeseen breakthrough, the October meeting promises to be as fruitless as the September one. What next? That we do not know, but we do know when "next" begins. On December 10, the ambassadors must report back to Ban Ki-moon the UN Secretary General. The Russians and the Serbs say that, after that, the process should continue, while the Americans, the British, the French and the Albanians say that that should be the end of it.

I began by saying that the Germans were again at the centre of attention in relation to Kosovo. The reason for this is simple. The US has said several times now that Kosovo should be independent and that failing agreement between the two sides, which is of course inevitable, should the Kosovo Albanians declare independence after December 10, then the US would like to recognise it, the seventh state to emerge from the wreckage of Yugoslavia. But will they do it? By itself US recognition is not worth so much, just as Turkish recognition of northern Cyprus is also not worth so much internationally. Britain and France would like to follow the US, but they do not want to do so alone. Indeed, the last few months have seen the hunt for the so-called "critical mass". Diplomats believe that should Germany agree to recognise Kosovo, then Italy would follow and then the bulk of EU states would come with them. If that is the case they do not expect that the sceptics and opponents of independence, Cyprus, Greece, Slovakia and perhaps Spain will prevent the replacement of the now crumbling UN mission in Kosovo with an ESDP mission.

So, when it comes to recognition all eyes are on the Germans. If the Germans feel that "talks" should continue then it seems likely that another delay is in prospect. Will the Albanians wait? They have been very patient until now, but in early October television showed film of an alleged paramilitary unit, the Albanian National Army. Serbian undercover police and military are also widely believed to be present in the Serbian run north of the territory and in the Serbian enclaves.

If it seems that a "critical mass" can be found then it seems likely that Kosovo will declare independence, if not in December, then early in the New Year. As the Security Council will have to examine the Troika's report and given the holiday period it is easy to imagine that this

will get postponed until early 2008 – and also in order to give the diplomats more time to work on their plans.

Serbia's leaders have played a clever hand, but their greatest fortune is in timing, which is to say that the Kosovo issue has returned to the international stage at precisely the moment that Russia is resurgent. Today the Serbian leadership says it does not want to rule Kosovo again, (and it is understood that it does not want to pay for two million hostile Albanians either,) and nor does it want to interfere in Kosovo's internal life, in the main because it does not want Albanian representatives back in Belgrade. It says it just wants to maintain its legal sovereignty, but that it will concede 95% of control to the Albanians. This, of course, is no more acceptable to the Kosovo Albanians than it would be to, say, Palestinians, but it has given rise to some speculation that the parties could be or should be offered a model similar to that of Hong Kong. It seems unlikely that the Albanians would ever accept this though.

In the short run delay might still work. In the long run it cannot. Violence would surely return and we may see a repetition of the scenario of the later 1990s when the moderate leadership of Ibrahim Rugova was eclipsed by that of the Kosovo Liberation Army. But, if there is a unilateral declaration of independence followed by bilateral recognitions, then equally we will face problems. The Serbian north of Kosovo will sever its last ties with the rest of the province and the fate of the Serbs in the enclaves (more than half of the total of up to 130,000 in Kosovo,) will be uncertain in the extreme. The loss of the north may well then provoke upheaval in the Albanian populated Presevo valley and also then in Macedonia. At the same time there are intellectual and other voices in Serbia arguing that Serbia should abandon the path of European integration in favour of some form of closer relationship with Russia. Indeed, last month, Serbia, already a member of Partnership for Peace, changed its official stance from one of wanting to join NATO to one of no longer expressing a desire to join the organisation. NATO is of course, since it bombed the Serbs, a none too popular organisation in Serbia but the question is to what extent this is the thin end of the wedge? Some Serbian ministers already say publicly that should many EU states recognise an independent Kosovo then Serbia should abandon its attempt to join it, and indeed should seek a closer relationship with Russia.



Russian companies are interested in investing in Serbia and some, such as Lukoil, are already there. Important privatisations in which Russian companies are said to be interested include JAT Serbian airlines, Belgrade airport, the Bor copper mines and NIS, the Serbian oil industry. Whether or not Russian companies are now given preferential treatment for political reasons remains to be seen. The other question is to what extent the Serbian threat – “we will go with Russia if you give Kosovo independence” is a credible threat – or even whether it matters. Serbia's population is after all barely that of greater London. The other question is what premier Vojislav Kostunica's partners in government, the more European oriented Democratic Party of President Boris Tadic, will do, if anything.

European policymakers are not faced with any good choices here and I have no space to dwell on Bosnia now. Suffice it to say that the political situation there has been blocked for the last year or so over the question of police reform. Both the main Bosniak (Bosnian Muslim) leader, Haris Silajdzic and Milorad Dodik, the prime minister of the Republika Srpska (the Serbian entity in Bosnia,) have maintained their opposing positions on this key question

because, in the end, they have fundamentally different visions about the future of the country. But, Kosovo is a factor here. Mr Dodik knows that Kosovo plays in his favour if it is going towards independence because it becomes hard to explain why independence is acceptable for Kosovo, legally part of Serbia, but not for the Republika Srpska. In the Balkans you can press in one area and the result is seen elsewhere. Mr Kostunica therefore has every interest in helping keeping the situation in Bosnia as it is while he is under pressure over Kosovo. The Albanians likewise can play similar games. That is to say the recent appearance of the Albanian National Army on TV, reminds people that there are Albanians who are prepared to put the issue of a Greater Albania back on the agenda if independence and Euroatlantic integration fail, at least in the way they have been foreseen up until now.

Difficult choices lie ahead and difficult days for the Balkans. In the longer term the region should prosper, but in the short-term, the Balkan ghetto, that is to say the Western Balkan enclave, minus Croatia, which is moving slowly but surely towards EU integration, is bound to face a difficult year because of Kosovo, which is above all a test for EU common resolve – or not. Moscow and Washington are both waiting to see what the EU will and can, or cannot do, and much rides on the outcome. In the short-term, if Serbia lurches towards Russia in some form, it is bound to slow the progress of the rest of the region towards the EU, but in the longer run it is an untenable position, because presumably, if Serbia decides it does not want to join then it will no longer be eligible for pre-accession funds from Brussels, and not being Switzerland, nor for that matter Croatia, its citizens will long remain trapped by a relatively hard visa regime. Foreign investors also will be far less keen on the country than they are at the moment. The EU itself may be able to buy time, if a decision on the final status of Kosovo is postponed, if it finds a way to replace the UN in Kosovo with its ESDP mission, but whether Kosovo Albanians would find that enough of an incentive to remain quiet remains to be seen.

This was written on 5 October 2007. By the time we meet, in three weeks in Vienna, I will arrive fresh from Kosovo, Belgrade, Bosnia and Croatia and so will be fully up to date and also happy to talk about the rest of the region which I could not do here, deciding, for matters of space, to concentrate on the most important issue at hand. The cartoon shows Serbia – as Little Red Riding Hood. It was published in “Vecernje Novosti”, the Belgrade daily, on 28 September 2007.

RECENT CONTRIBUTIONS FROM TRILATERAL COMMISSION MEMBERS

"SERBIA AND THE EU: MLADIC FIRST, THEN TALKS"

BY CHRIS PATTEN

11 October 2007, EU Observer

Somewhere in Serbia the architect of the horrific 1995 Srebrenica massacre, Ratko Mladic, is walking freely, enjoying the tacit and furtive protection of the state. Somewhere in Europe, probably Brussels, EU diplomats and politicians are preparing to give him a new lease on liberty.

Next week, the Chief Prosecutor for the International Criminal Tribunal for the former Yugoslavia, Carla Del Ponte, will report to EU foreign ministers on Serbia's cooperation in handing over war crimes suspects to The Hague. Her report has significant implications for present and future EU policy in the Balkans. As recently as 3 October she has indicated that Belgrade is not providing sufficient cooperation, but behind the scenes Brussels is pressuring Del Ponte to go easy on Belgrade so that it can sign a Stabilisation and Association Agreement with Serbia, a key step towards membership negotiations.

Some are even arguing that Serbia should be accelerated to candidate member status, perhaps as early as next year, in spite of the fact that Serbia continues to flout one of the EU's main criteria for signing a stabilisation deal: the arrest of war crimes suspects, in particular Mr Mladic.

So why is Brussels in a rush to willingly drop its standards? The answer you hear is Kosovo. The EU is deeply divided over Kosovo's impending independence, which will most probably be declared by Pristina without a UN Security Council resolution in early 2008. Some EU member states -- Greece, Cyprus, Slovakia, and Romania -- deeply oppose recognising an independent Kosovo without a Security Council resolution and will only reluctantly permit the EU to put a civilian supervisory mission in place to replace the current UN mission, and only provided the EU does all it can to try and demonstrate good will towards Belgrade.

Others in the EU, while hoping for a Security Council resolution, are willing to recognise an independent Kosovo without one, but agree that Brussels should give Serbia something in return. That something is rapid progress on the road to EU membership.

Such a coupling of the two issues, however, is tragically misguided. To move Belgrade forward in the accession process, the EU would have to drop the principles and conditions it demanded of other countries in the Balkans, with negative consequences for the region. Bosnia, Croatia, Macedonia and Montenegro have all made significant sacrifices on the road to European integration. At great cost, Bosnia has fulfilled all the EU Stabilisation criteria except for police reform, and could soon see progress even in that sphere. Croatia has had to arrest all its war crimes suspects, in the process shaking out its intelligence services and judiciary. Macedonia has had to undertake numerous painful reforms and also subject itself to the Hague Tribunal's jurisdiction. Montenegro has begun a rigorous internal reform process against substantial opposition and cooperated fully with The Hague.

Belgrade, on the other hand, continues to harbour Mr Mladic and quite possibly Radovan Karadzic, the Bosnian Serb political leader. For years it was an open secret among Serbia's political elite that Mladic enjoyed the protection of the state and that he was untouchable. Nothing has changed.

Dropping conditionality for Serbia will tell the rest of the Balkan countries that rules and standards don't matter and will surrender what little leverage the EU has over Belgrade. It will encourage

Bosnian politicians to obstruct police reform. It will encourage Croatia's politicians to drag their feet on refugee return and restitution.

It will tell Macedonia and Montenegro that they can fudge on the accession process. It will tell Kosovo that it need not take seriously the implementation of the standards in the UN-sponsored plan for its supervised independence. It will also anger Bosnia, Croatia, Macedonia and Montenegro, who see Serbian misbehaviour consistently rewarded by Brussels and feel a double standard is in place.

Surrendering European principles will not produce the desired result. It will not change Belgrade's policy on The Hague Tribunal or Kosovo. Rather, nationalist hard-liners will see this as a vindication of their policies, and it will weaken Serbia's democratic forces, who will be shown to have been fools for having supported EU standards.

Serbia cannot take a step on the road to Europe while still wearing the leg irons of Mladic and Karadzic. The best intentions of Europe aside, only Serbia can free itself of these shackles. The EU's message to Serbia should be clear: no Mladic, no Stabilisation Agreement.

The author, former European commissioner for external relations, is chairman of the board of the International Crisis Group.

SPEAKING NOTES AT THE CROATIA SUMMIT 2007 ON "EUROPE'S NEW SOUTH"

BY DR. ZBIGNIEW BRZEZINKI⁴

Dubrovnik, 7th July 2007

Speaking on May 11th at the Zagreb Summit of the South East European Cooperation Process Conference, the President of Croatia made two statements that I wish to use as the point of departure for my own observations. The President said: "Our citizens and in particular politicians have to be aware that a stable future can be built on reconciliation, coexistence and tolerance among ethnic groups". And then he added that "without stability in the surrounding area, there is no economic recovery and no progress" and he warned that "the stability of this area is still very questionable".

I agree and want to focus my remarks on the issue of the region's stability and then on the relationship of that stability to the wider international context.

Today's Europe – once the cradle of nationalist passions – **is pioneering in the institutionalization of voluntary pooled sovereignty, and in that respect is an example to the world.** It stands in sharp contrast to the former Soviet Bloc, to the Soviet Union itself, and to the former Yugoslavia.

That is why **the further expansion of the EU – and of its collective security alliance with the US through NATO – is historically desirable.** Its expansion is a contribution to a more civilized world system. It enlarges the zone of peace and social progress. I realize that some say that Europe is suffering from a justifiable "expansion fatigue" but let us be careful that the notion of "fatigue" does not become an excuse for selfish and exclusive self-indulgence. It can also become a cause of instability that adversely affects even the EU.

⁴ *Founding Director of The Trilateral Commission*

To be sure, expansion has to involve the voluntary consent of new members to pool sovereignty but it also must be based on adherence to strict standards for membership. The recent surfacing of some serious problems with corruption and legal standards in lately admitted EU members underlines the point that expansion must be based on the very strict compliance of would-be members with all declared standards for membership. Otherwise both the integrity and the coherence of the EU will be in jeopardy.

And so I say: let us continue to expand the scope of the Euro-Atlantic Community but also enforce all its rules for membership. But let us not fear expansion: just think how insecure Europe today would be if the Baltic States had not been admitted both to NATO and to the EU.

It follows that **Croatia** should soon be welcomed to NATO and before long to the EU, and that **Macedonia** and **Albania** should subsequently follow suit. It also follows that in this region of Europe, often referred to as the Balkans, the people of **Kosovo** deserve self-determination and it should not be locked by governments that have a historic record of denying self-determination to others than themselves. It also follows that **eventually all the states of this region should be included in the Euro-Atlantic Community.**

This region of Europe thus faces a daunting but also a hopeful agenda.

Its historic challenge is to transform the very notion of the Balkans from an internationally troubling region of conflict into a region admired both for its natural beauty and for its quality of life – much like Scandinavia has become. Scandinavia in the north, *Balkania* in the south will then be the truly appealing symbols of what Europe has to offer in every important dimension of human life, ranging from the aesthetic to the material. With the EU expanding and NATO enlarging, that attractive vision of the future is neither elusive nor distant.

But as noted earlier, **regional progress here cannot be insulated from problems originating from nearby.** Three potential dangers loom on the outside, they tend to be inter-related, and they could impact adversely on this region:

1. In the long run **it is desirable that Russia becomes more closely engaged with the Euro-Atlantic community.** That will also help Russia's eventual transformation into a genuinely democratic state, to the benefit of all concerned. But that will not happen if Ukraine does not in the meantime become a more integral part both of NATO and the EU. A Ukraine visibly moving into Europe is a Ukraine that accelerates and facilitates a similar process by Russia (and it has already done so in regards to the WTO) – and it diminishes the temptation for Russia to pressure both Ukraine and Georgia to again be subordinate to Moscow or to exploit in this region Serbia's nostalgia for the past.
2. **It is also desirable that the gates to the EU remain open to Turkey if it satisfies the criteria for membership.** Turkey is connected to this region by history, by geography, and by physical presence including troops in Kosovo. A Turkey excluded from Europe could become a suddenly unpredictable Turkey, a potential transmission-belt to Europe of the sectarian violence currently escalating in the Middle east, perhaps reorienting its foreign policy vis-à-vis Russia or Iran. The Euro-Atlantic community should not turn its back on Turkey, for its own sake and for the sake of this region.
3. Last but not least, **much depends also on how in the near future the US copes with the several challenges it now confronts near-by, in the Middle East.** That region has become the test case of America's ability to act as the global leader. Failure to end the war in Iraq, to negotiate with Iran would again strain US-EU relations, to the detriment of the wellbeing of this region, and to the benefit of those who oppose the emergence of a still larger Euro-Atlantic community based on genuine reconciliation and the voluntary pooling of sovereignty.

These three dangers, alone or together, could damage the prospects for SEE Cooperation and even threaten international peace. This is why it is so essential that each of them be avoided.

The key in each case is **a more solid, more strategic, more systematic American-European cooperation.** That has been lacking during the last five years. The trans-Atlantic divisions have become both geopolitical and personal. Fortunately, there is now a new European leadership – Angela Merkel, Nicolas Sarkozy, Gordon Brown – and before too long there will be a new US president. If Europe speaks clearly and with one voice, America will have to listen. And with America and Europe again working together, the mistakes of the recent past and the dangers lurking in the future can be avoided. But make no mistake about it: the next 18 months will be critical both for the future of this region and for the character of international affairs more generally.

REUTERS, Brussels, March 19, 2007:

Holbrooke warns of Kosovo explosion if plan stalls

Former U.S. Balkans peace broker Richard Holbrooke said on Monday that violence could explode in Kosovo as early as next month if Russia stalls a U.N. plan to give the breakaway southern Serbian province independence. Holbrooke, who brokered a 1995 peace accord for Bosnia, told reporters the Western-backed plan for supervised independence drafted by former Finnish President Martti Ahtisaari was the best possible solution under the circumstances.

"If the Russians delay or dilute or veto it, then I'm afraid the long pent-up desire of the Albanians in Kosovo for a rapid move toward independence will explode into violence," he said. NATO forces responsible for peacekeeping would need to be ready to act quickly to prevent an escalation of violence when the matter is debated in the U.N. Security Council next month, the former U.S. ambassador to the United Nations said.

Holbrooke was **in Brussels** for a closed-door **meeting of the Trilateral Commission** of business and opinion leaders from the United States, Europe and Asia. *"The Russians should be aware of the consequences of their actions in New York,"* he said, accusing Moscow of emboldening hardliners in Belgrade by saying it would not support any plan the Serbians oppose...

THE OTTOMAN SWEDE

by Roger Cohen

International Herald Tribune, 12th September 2007

STOCKHOLM: As members of Congress mull what to do in Iraq, they might glance at a League of Nations report of July 16, 1925, on the new Middle Eastern state then being carved by the British from the wreckage of the Ottoman Empire.

The report said that despite "the good intentions of the statesmen of Iraq, whose political experience is necessarily small, it is to be feared that serious difficulties may arise out of the

differences which in some cases exist in regard to political ideas between the Shiites of the South and the Sunnites of the North, the racial differences between Arabs and Kurds, and the necessity of keeping the turbulent tribes under control." And it warned: "These difficulties might be fatal to the very existence of the State if it were left without support and guidance."

So much for things changing. They don't, or only slowly, when attempts are made to carve sustainable nation states from multiethnic empires.

This 82-year-old document was handed to me by **Carl Bildt**, the Swedish foreign minister, a man of dry humor and quick tongue who can claim to be the world's authority on the messes in post-Ottoman areas. "*From Bihac to Basra*," he said, referring to towns in western Bosnia and southern Iraq, "*these things take time, and benchmarks don't count for much.*" Bildt recently returned from Baghdad, where Sweden has much to discuss given that 20,000 Iraqi refugees are expected to arrive here this year, a number that dwarfs the trickle of fleeing Iraqis into the United States. This imbalance is shameful, but that's another story. In the Iraqi capital, Bildt heard divergent political visions from Nuri Kamal al-Maliki, the Shiite prime minister, and Tariq al-Hashemi, the Sunni vice president. The notion of give-and-take, of compromise reached rather than domination imposed, is new to the Middle East.

Give-and-take has not been much of a **Balkan** thing either, and it was in the Balkans, as a special envoy for the European Union, that Bildt cut his teeth on post-Ottoman mayhem. He is struck by the "massive parallels" between Yugoslavia's violent dismemberment once dictatorship ended and Iraq's turbulent deliverance from tyranny.

Both states were invented in the post-World-War-I years in areas long under complete or partial Ottoman domination. Both were beautiful inventions, bridges between divergent cultures and religions and ethnic groups, mosaics beneath a national flag. Both had the drawback of tending incurably toward their own self-destruction in the absence of a strongman to resolve contradiction through force.

Freedom is a funny word. Life without it is misery. But a glance at the Soviet Union or Yugoslavia or now Iraq is sufficient reminder that distinct peoples forcefully gathered into a dictatorial state will react in the first instance to liberty by trying to get free of one another rather than trying to imagine a liberal democracy. As Miroslav Hroch, the Czech political theorist, has observed, ethnic or religious nationalism easily become the "substitutes for factors of integration in a disintegrating nation."

That's where we are in Iraq. In plotting a social revolution - the ushering to power of a long subjugated Shiite majority through the overthrow of a Sunni dictatorship - the Bush administration did not ponder or plan for these realities. That's unfortunate, indeed unforgivable, but it's done.

Bildt, Balkan-hardened, takes the long view. "If you take the Ottoman areas, they were Muslim but tolerant, with an array of different cultures, and their replacement with a different version of the 19th-century nation state has turned out very difficult, be it in the Balkans, in Cyprus, or the Middle East." He cannot imagine a quick American exit. "Iraqi leaders will want some sort of exit perspective, but a long-term one," he says. As long as Iran and Saudi Arabia see Iraq as a Shia-Sunni battlefield, peace will be elusive.

The Balkan analogy is interesting. Yugoslavia's break-up saw four years of war, then another violent spasm in Kosovo four years later. Only regional pressure - the draw of EU membership - and a large European and American troop presence brought calm. **The question of Kosovo's independence from Serbia remains explosive.** That is a 16-year arc from the eruption of the Balkan wars in 1991. Given that regional realities make a break-up of Iraq unthinkable, the

architecture of the Yugoslavia-in-miniature in Bosnia is probably the most helpful guide for Baghdad: a fig-leaf national government presiding over a loose federation.

If the United States meets its responsibilities and the region can be coaxed to help rather than hinder, we may get there over 16 years from Saddam's fall: that would be 2019, just over a century after the Ottoman collapse.

"HOW'S THE WEATHER, JEEVES?"

Exceptionally clement, Sir.

Anything in the papers?

Some slight friction threatening in the Balkans, Sir.
Otherwise, nothing"

P.G. Wodehouse, *The Inimitable Jeeves*, 1928

WESTERN BALKANS AND THE EU:

BEFORE, THROUGH AND AFTER THE KOSOVO EARTHQUAKE

BY GORAN SVILANOVIC

Chair, Working Table I, SP SEE;
Former Minister of Foreign Affairs of SCG

The process of resolving a future status of Kosovo (the process) is going to be the first for recently formalized joint EU foreign policy. In case of Kosovo, the EU chooses between its internal unity in practice and the regional stability. If the EU fails to demonstrate more decisiveness, the Lisbon Reform Treaty may turn out to be a stillborn baby, despite an initial optimism that followed it.

The fact that the process occurs in times pretty much different from those in which the military intervention was taken and the UN SC Resolution 1244 was adopted slows it down and introduces new stakes that must be taken into the consideration. Still, it has no alternative, as the *status quo* has become counterproductive several years ago. Any further prolongation would cause deepening of existing problems that the region faces as a whole as a direct consequence of the Kosovo *status quo*. Some of them have already caused harsh damage, some may mutate into irrevocable ones, but all of them are in the EU backyard. The Troika format seems to be a good one so far. Still, the spotlights are turned on the EU much more than on Belgrade and Prishtina, or Russia and the US. Even the US call for “creative proposals” seems directed more towards the EU than to the Albanians or Serbs, who may be, under the Troika auspice, persuaded to comply if the EU offers something substantial. Item 7 of the Troika document, presented on last Saturday, which says: “Belgrade and Prishtina are determined to make progress towards association and eventually membership of the European Union as well as to move progressively towards Euro-Atlantic structures,” is a vague but welcomed sign in that direction. Let’s hope that Serbian and Kosovo negotiating teams will agree on that one as an important goal of both sides.

Current political seismic dynamics in the WB

But the message from the EU side about the clear EU perspective for the entire Western Balkans (WB) is still missing. Despite all the achievements that the WB countries have made so far, the general notion towards lasting stability and development under Euro-Atlantic integrations mechanisms auspice is on shaky grounds. Current stalemate, no matter how justified from the fulfillment of the standards point of view, causes an inflation of an incentive that a EU membership, which hangs in the air, can deliver. The Macedonian government, which EU progress has been called off for almost two years now, has very high approvals in public. In Serbia, the pro-EU option gets peaks in polls when something in particular happens, no matter whether the general public has a clue what this “something” is. Institutional crisis in Bosnia that is growing on daily basis or the obvious shift in the Serbian foreign policy can also be resolved only within a wider frame of the future of WB as a whole as dreams about additional reshuffling of borders in the region have never ceased to exist.

KOSOVO EARTHQUAKE AND HOW TO ABSORB SHOCKS

Lets make no mistake, no matter how the final status is going to be phrased, no matter who may declare a victory, no matter if it is going to be a result of a wide compromise or a result of the chain effect caused by a unilateral declaration of the independence (UDI) followed by series of bilateral recognitions, it is going, actually it already is, an earthquake that shakes the entire region, with the strongest peak yet to come, as well with all the aftershocks. Prishtina will never control North Mitrovica, and Belgrade will never again control Prishtina for the start. No one can count for sure that Serbian and Kosovo officials do control entirely all armed and intelligence structures, after the appearance of ANA and the beating up of the Voice of America Serbian correspondent. March 17, 2004 is still fresh in mind, as it should be. A single unplanned incident may trigger violence, or even more evitable — refugee streams.

A regional frame to the solution -- with strong and elaborated incentives for the EU membership for all of the WB countries — may be the only one that can absorb and amortize forthcoming shocks. Aftermath side effects must also be envisaged and strategies for their absorption developed. Serbia has already started to slow down regional cooperation that is a precondition for the EU membership, and announces further steps like withdrawal from the Stability Pact's created Energy Community, even before the final status of Kosovo is reached. Reducing levels of cooperation in the future in case of an unfavorable solution for the Serbian side, which is very likely, will dramatically intensify this course and thus “punish” all other WB countries. Item 3 of the mentioned Troika proposal which states that: “Kosovo will be fully integrated into regional structures, particularly those involving economic cooperation”, that no side in the talks has challenged so far, gives grounds for optimism in that regard.

Kosovo should be seen not as an isolated problem but merely as a step towards achieving the goal of completing another round of the enlargement. If the EU voters were successfully persuaded that they needed not referendums on the Treaty, I am deeply convinced that some smart and sincere arguments from the EU leaders can help them understand that the WB accession is not a threat but rather the process with mutual benefit in a final long term outcome, just as previous enlargements. The absorption fatigue notion, particularly after the Lisbon success, may seem as an easy challenge to be resolved in comparison to what lies ahead of the EU throughout the world.

WB BEFORE THE BIG SHOCK

In the course of the past nine years, the main objective of stabilizing the Western Balkans has certainly been achieved. The remaining tasks are thus to ensure a long-term sustainability of co-operation processes by enhancing regional commitment and ownership and to support the countries of the region on their path towards Euro-Atlantic integration and globalization. All the countries of South Eastern Europe as well as UNMIK/Kosovo signed a new and improved Central European Free Trade Agreement (CEFTA) in December 2006, creating a free trade area in South Eastern Europe. Demonstrating a new level of maturity and awareness of need to respond regionally to global challenges, countries of South Eastern Europe undertook in November 2006 another step forward towards the creation of a new regional co-operation framework that will gradually take over the responsibilities of the Stability Pact for South

Eastern Europe. Montenegro signed its SAA in October 2007, and Serbia has successfully completed the technical part of the negotiation and is ready to sign.

Contrary to other regions where it has its ups and evident downs, democracy promotion has rooted deep into all layers of otherwise very incoherent societies of the Western Balkans. The region has a comparative advantage of being settled in South-eastern Europe, surrounded with EU members and candidates and NATO founders, in proximity of countries that already benefited from the EU enlargement. The region has one more comparative advantage on its side. NATO is emerging as a leading political structure with a new role to protect achievements of the Western civilization: democracy, rule of law, prosperous economies and human security. NATO has a potential of overcoming functionality problems that are imposed by different EU accession geometries of the WB and SEE. While WB countries are in several different phases of the EU integration process, they are progressing towards NATO membership faster than towards the EU. An enhanced NATO focus on the WB corresponds with the Alliance's initiative to create closer military ties with countries throughout the world as announced during Riga Summit 2006. Invitation for the next year membership extended to Croatia, Albania and Macedonia is good news, as well Serbia's long awaited PfP membership.

WHAT THE WB NEEDS TO SURVIVE THE BIG SHOCK AND UNSTEADY AFTERMATH?

The WB needs another spotlight of focused and coordinated involvement of the EU that would help both sides to preserve the investments and the already achieved accomplishments. Further measures should mean less conditionality and more supportive engagements. Until recently its future seemed more or less determined. Successful reconstruction period embedded the foundations of democracy and rule of law in all the countries of the region. Structures like OSCE, CoE, PfP and mechanisms like SAA, were mighty allies in shaping the region's future. But WB leaders' and citizens' declarative will to join Euro-Atlantic integration does not always match their real efforts to educate their citizens for democracy, tolerance, social cohesion, rule of law and open market economies. At the moment leaders and people of the WB fell dizzy and confused. Without a proper safety net, the earthquake that the settlement of the Kosovo status will cause one way or another, the EU is risking to ruin much of its efforts and investments that it has made into the region so far. It is obvious that further commitments by the EU to the remaining Western Balkans countries on the full membership are a must. That will reduce challenges of further confrontation and pamper some of the earthquake side effects. It will give a new necessary incentive for the governments to move on from a current *status quo* and successfully overcome remaining challenges of the democratic consolidation, like arrest and punishment of indicted war criminals, containing corruption and monopolies. By doing so, the EU will make leaders and people of the Region being busy, instead of becoming unconstructive once again, if they do not see the clear perspective. It seems at this moment, that NATO understands the dynamics better than the EU.

Bearing all the above-mentioned in mind, when it comes down to the WB, the question is no longer: "What should be done?" as the EU should clearly bring the region into the EU. It is "How?" that should be elaborated in more detail under the newly emerging circumstances. Clear time sequencing of policy steps that have to be undertaken and the structure of incentives that will make them work is the missing link. We need policies so that the region can get on, get in and catch up with the rest of Europe.

The International Commission for Balkans (ICB) of which I was a member, in its 2005 Report acknowledged that there were no quick and easy solutions for the Balkans and that ultimately it is up to the people of the region to win their own future. Still, the Commission underlined that the European Union in particular has a historical responsibility to face and a decisive role to play in winning the future for the region.

Let me give you two more arguments for that line of reasoning before I give you an outline of exact steps that the WB countries and the EU should undertake in the forthcoming period in order to fulfil this task. The first one is my strong conviction, that I have presented on numerous occasions during my Stability Pact term, that the WB accession is not merely a historic responsibility of the EU as the ICB put it, but equally an opportunity for the EU to respond more flexibly and effectively to racing global challenges like energy dependency, migrations and terrorism to mention just a few. The second one is also a pragmatic one - what is going to happen with all the investments, financial as well as political, that the EU has made in the WB so far, if it does not give it a clear EU perspective? Bearing in mind current problems that the *status quo* of Kosovo status has caused up to now, with all the shocks that the region has yet to face, a stable backyard, no matter how untidy, does not seem as a feasible outcome.

The WB *status quo* towards full EU membership is as counterproductive as the Kosovo *status quo* one has been. Saying all this, I do not say that politicians and voters of the WB countries should stand still and wait for the EU to move on. On the contrary, they just should be engaged in a different manner that will keep them engaged and busy in a constructive way, which is not always a case at the moment, as some inconsistent and vague EU messages make them dizzy instead. I hope that the newly established Regional Cooperation Council (RCC), a successor of the SP SEE, will be a useful and comprehensive framework for that.

What the WB countries should do help the EU to help them

- Use EU tax payer's devotion to application of soft power by making additional effort to promote EU-WB policy as a success story too, emphasizing already-made EU political and financial commitments in the WB. Administrations of countries of the region should make an effort to improve resources and skills in order are able to use as much money as possible from already existing EU funds –allocated through Instruments of Pre-accession Assistance (IPA)
- Do its best, by improving integrated border management and control over illegal migration, to crack a tendency to view further enlargement as a threat to the quality of life enjoyed by the peoples of the Union. This reflects a myopic view of security in a global age which no longer can be identified with guarding the borders of the Union. Give evidence and act in according manner to prove that the preservation of the EU zone of prosperity and democracy depends on its extension.
- Put CEFTA into full effect, as it is a testimony to the commitment of the region to increase its competitiveness, maximize new investment and further enhance access to European markets.
- Focus on Economic and Social Development, Infrastructure, Justice and Home Affairs, Security Co-operation and Building Human Capital, with Parliamentary Co-operation an overarching theme that is linked with each of these priority areas under the RCC auspice.

- Start translate EU values more vigorously and with less opportunism, as well getting to know mechanisms and patterns of reaching decisions, bearing in mind the novelties in the Reform Treaty.
- Continue to develop civil society as a credible social actor.
- Leaders of the region should be engaged in permanent debate with the general public on issues related to enlargement policies and reforms processes in their countries. Leaders of the former Yugoslavia countries should keep an open and enhanced comprehensive dialogue on the recent past and responsibilities for war crimes.

WHAT THE EU SHOULD DO FOR THE WB

On the short run, the EU has to continue to demonstrate more decisiveness with regard of resolving the final status of Kosovo. Even if the Troika talks fail, the process should continue with the upper hand of the EU. With regard to non-Kosovo issues, the EU should start rapidly removing the existing “Schengen wall” visa regime and restructuring it financial assistance more in favour of non-candidate and non-member states. At the long run the EU should rephrase its current SAA-candidacy status- candidacy talks – process into a more level graduated process of guided building of member states. This also should start as soon as possible, no matter how long it should take until all the criteria are met. Without that the EU allure is going to continue to fade, as we can clearly see in cases of Serbia, Macedonia and Bosnia.

1. The WB on the White Schengen list

It would be of a crucial importance for the Region if the EU manages to speed up entrance to the so-called white Schengen list of the entire Western Balkans, which is steadily opening up to the global economy. Opening has been induced predominantly from the outside by IFI requirements and foreign investor’s interests, and heavily politically and financially supported by them. The EU with its new members Bulgaria and Romania is now encircling the Western Balkans geographically. Without the entire region on the white Schengen list, the results of CEFTA and other regional initiatives related to liberation of movements of capital, goods and services in the region would be significantly undermined.

This situation is already putting people and companies as well as investors in the Western Balkans in a frustrating situation that is by all means in contradiction with progress being made and level of direct investments and aid allocated by USA, EU and international organisations into the region so far. Prospect of isolation challenges investments made so far and increasingly impede region’s potential for transformation from a zone of stabilization and integration to the zone of growth. In the meantime, a capsulated region has to cope with an unavoidable damping and outsourcing economical effects of globalization, as well as with security threats.

2. Inversing of the financial assistance pyramid

Middle – income countries of the WB need broad and deep institutional reforms in government, banking, and law to transform economies that stifle innovation into ones that foster it with strong property-rights regimes, effective financial systems and good governance, that would help them become functional states.

In order to achieve that, the WB needs a new generation of policies that focuses on democratization and quality of political representation, which can consolidate and strengthen pro-reform and pro-Euro-Atlantic forces in their societies. The region must, therefore, be assisted in investing in building human capital that will be capable of implementing these policies, while carrying on integration processes, along with improving functionality and accountability of states—EU member states.

Countries that are closer to the EU receive at the moment more money from the EU programs than those further back in the line. In the same time they have stronger infrastructure and human resources that can drag more of the offered assistance than administration in the countries further down the line. This make for a new type of gap among them that is unnecessary bearing in mind how small they actually are from the EU funds point of view. On the other hand, being small and left with less assistance, they are facing serious threat of loosing a dynamics of coping with globalisation trends. Being forced to open their markets by IFIs, they are, under the current circumstances, closer to dumping down rather to “teching” up, which seem to be the only way through the globalisation labyrinth. It will take some time before they can start yielding benefits from the CEFTA agreement. The results of enhanced investments in human capital, a goal set by RCC as well, also need some time before they show up. The EU should develop additional lines of supporting them or restructuring the existing ones that will enable them to bridge the currently widening gap. They will hardly be able to do it on their own, no matter how well they behave in terms of the economic and fiscal reforms and demonstrate successful economic growth of app 6% per year in average. By doing so, the EU would simply level the field, which is a just and fair incentive to be given, bearing in mind that they are encircled with the new EU countries, which have received more from the “member only funds.”

3. Guided ‘member- state’ building strategy.

The Balkans needs a new strategy if it is to translate Brussels' stated political aim to integrate the region into reality. Despite the commitment made at Thessaloniki, the remote dream of European integration is not powerful enough as a force for transforming societies of the Balkans, especially if we agree that the basic indicator of success is the progress of each country on the road to the EU.

Of course, the EU itself faces a significant dilemma as it has the capacity to absorb only reasonably functioning and legitimate states. But now that Croatia appears on the verge of the full accession process, there are no more of these left in the region. The classical enlargement model that worked for Central and Eastern Europe in 1990 simply does not fit the conditions prevailing in the Balkans these days. If the region is to become part of the EU, it needs to undergo significant changes. But it can go through them more rapidly and steadily from the candidacy status on than “only” with SAA at hand.

The Stabilization and Association Process is not strong enough as a framework for building member states as it used to be, as the *status quo* in general and the Kosovo status determination have eroded it. Once tailored made and applicable SAA conditions, like the EU constitution that evolved into the Reform Treaty or ICB 2006 Report that need to be updated, the Copenhagen Criteria dynamics and the SEE have to be upgraded and adjusted to the new circumstances. The best in them should be preserved, and some of the things should simply be rephrased or extended into a next phase as a token of confidence demonstrated by the EU. By doing so, the EU can continue to extract the best of these countries without giving up the ultimate goal - helping the individual WB countries becoming full EU members.

With new post Lisbon optimism, the EU is in a better situation to contain the Kosovo case into a wider WB framework by offering all remaining WB countries new dynamics and a layout for access to the EU. Giving them a candidacy status even if they have not met all the Copenhagen criteria, as long as they are on the steady path to achieve them, should be taken into consideration as an option that may transfer the current stalemate into palpable reality. In the Balkans of a post Kosovo status period, the accession strategy should be a mixture of classical state-building policies with those aimed at transforming nation states into member states, with a chain of smaller steps that should be awarded and recognized. The membership negotiations should, of course, take as much as they need, before the criteria are met, but a general feeling of being guided and recognized as a future member should be re-introduced. What we face in the Balkans is a need for a guided 'member- state building' strategy. That would blow fresh wind into the sails of genuinely pro EU forces in Serbia, in Kosovo, in Macedonia, and in Bosnia and Herzegovina, as they seem to be outmaneuvered by stubborn national leaders and local players that keep both the EU and the entire region as hostages of their current policies.

The experience of Central and Eastern Europe illustrates best how the institutionalization of the European perspective is the most efficient way to foster and accelerate the overall political, economic and administrative reforms in aspirant countries. This does not mean that all Balkan countries should join the EU at the same time, but it does mean an end to the fears of some Balkan societies that they might be left out of the process altogether or without an applicable blueprint for accession.

EU and the WB: –

From a regional payer to global player or an Impotent Empire

Everyone should be aware that failure is also a very real prospect and that the consequences of failure could be grave indeed. If the EU does not come out with a broader context in which the Kosovo settlement earthquake can be amortized, if it does not devise a bold strategy for accession that could encompass all Balkan countries as new members once when they do meet all the existing criteria, then it will become mired instead as a neo-colonial power in places like Serbia, Kosovo, Bosnia, and even Macedonia. Such an anachronism would be hard to manage and would be in contradiction with the very nature of the European Union. The real choice the EU is facing in the Balkans is: Enlargement or an impotent Empire.

If this happens, the prospects that the Lisbon Reform Treaty has opened for a united EU foreign policy may be narrowed on the world scale too. On the other hand, full integration of the WB in the EU, the new enlargement, will be a clear signal that the EU has evolved from a regional and global *payer* to a global *player* with a recognizable style- a successful crossover between Realpolitik and the idealistic promotion of peace, democracy, and prosperity.

Belgrade, October 23, 2007

THE ORGANISATION FOR SECURITY & COOPERATION IN EUROPE

BY MARC PERRIN DE BRICHAMBAUT

Secretary General, OSCE, Vienna

SUMMARY

The OSCE brings together all the key actors on all burning issues, from Kosovo to arms control, central Asia, etc. However promising a forum it seems to be, it **is undergoing a lack of commitment from all three major players.**

The EU enjoys a majority among OSCE's 56 Member States, as up to 8 more countries use to vote together with the 27. But this leverage is left in abeyance, since Europe fails to come up with strong positions - let alone to take leadership. The decision-making process ends up into weak compromises, and can only be improved when an influent country chairs the EU and wishes to push issues in a more resolute manner. Germany for example was good at it.

One would expect the Americans to take advantage of the entire favourable context OSCE can provide to their policies, and seek to expand their influence further, using the Organisation as a Trojan horse. The sad reality is that on the contrary they treat it badly, try to trim it down, and neglect the help it can offer.

The Russian Federation, to which OSCE offers an open field for diplomatic manoeuvring, keeps on the contrary challenging the Organisation's legitimacy, in particular in the field of democracy watching and elections monitoring. Russia sees the future of the OSCE as a return to its initial role of a forum. Vladimir Putin carefully chose his words when he publicly coined it as a "vulgar organisation", which sets the tone.

OSCE's life is rocked by the diverging attitudes of its three main actors, and the Organisation seems doomed either to turn into a confrontational arena or to be drastically shrunk. We would then be left with the situation we had when the process began thirty years ago in the wake of the Helsinki conference, which did open up the change we have witnessed since, but did not comprise all the improvements brought about in the course of OSCE's life.

However, **all three key players keep a wisely cautious profile**, making sure that the Organisation remains up and running, **but dark days might come quickly** for this very efficient and original instrument of cooperation across the Northern Hemisphere.

SESSION ON THE EU:
THE FINANCIAL SCENE, FROM A SURGE IN GLOBAL LIQUIDITIES TO CREDIT
CRUNCH

SUMMARY

2007 began as a year of historically lavish liquidity of all markets. It is ending, quite opposite, in the wake of the dangerous turmoil occasioned by the **liquidity drying last summer.**

Since early summer, financial markets have experienced tensions, market volatility has risen, and market liquidity has sharply declined, in several asset classes, a result of a substantial increase in risk aversion and the repricing of risks. Particularly the markets for structure finance products, and the interbank money markets, have been severely affected by a loss of confidence in the value of finance products. Credit conditions have been tightened, and the outlook is surrounded now by greater uncertainties.

This has revealed **structural weaknesses, which had already been**, pointed at earlier by central banks, in particular the ability of banks to manage risk adequately in a changing complex environment.

Altogether, the crisis has checked with success the **resilience and reactivity of the system as a whole**, and **the liquidity shortage was met adequately**, though in different manners, **by central banks**. Considering each the economic situation in their area of core responsibility, the FED eased credit by lowering rates significantly, whereas the ECB preferred to keep its monetary policy tight, so as to keep focus on its ultimate goal, while shedding liquidities in due proportion to keep the markets going. The Bank of England took a more “puritan” position, leaving to a certain extent the banks with the risks they had unwisely taken. Even if the situation could have been better anticipated and dealt with, the global picture shows a **prompt and adequate response to an unexpected situation.**

The crisis has demonstrated that **it was by no means a liquidity crisis**, even if it was made worse by the reluctance of all banks to lend, as long as they had no clear idea neither of the risk position of their counterpart, nor of their own.

This is where the problem lies : the smart **model of “originating and distributing”**, which consists in spraying the risks created by a loan across many banks and non-bank financial institutions, through sophisticated instruments like conduits, has led all, or most banks, to create risks *off* their books, so to say, therefore creating a situation in which risk management and supervision was bound to be poor.

These risks were assets-backed, and the subprime mechanism had resulted in swelling the building business up, as many more people could buy houses. The mortgage underpinning their loan was expected to gain value because of demand’s pressure, and pay the loan back quite easily. So the money in was creating more money out, which banks could not refrain from expecting to harvest.

In July, Moody’s downgraded the rating of 131 financial institutions because of their overexposure to risk in that branch of the business, and announced more reviews to come. The market became immediately tense and nervous, and there was a dash for cash. The more so because central banks and supervisors had circulated warnings earlier, so everybody could guess that the first turn around would entail a major backlash. Everyone then rightly tried to furl the sails first, so as to remain safe through the mayhem, and this created the mayhem.

When, as a result, the market swiftly turned upside down, the sad reality was that no more money out from the housing sector would pay back the money earlier poured in. A whole range of loans had to be written off as losses. Greed for liquidity trickled up the various segments of the market, to reach promptly the interbank monetary market, where the liquidity shortage was fully unravelled. From there on, it was bound to flash back on all segments of the market, thus leveraging a major breakdown, unless the need for liquidity on that ultimate refunding market was adequately met, as banks were not prone to lend to each other any more.

The banks had to refund themselves, and this increase in demand for liquidity, combined with the brutal upgrading of distrust, caused the rates to rise, credit to crunch, and the liquidity of economy to become much more volatile. The direct exposure of banks to the

subprime market collapse varied considerably from one to the other, but almost all of them experienced indirect exposure through the financial instruments, and due to the sharp drawback in confidence across the board.

Central banks were able to monitor the turmoil and cooled it down fairly well by tallying the need for refunding at the exactly appropriate level. **Global economy was hardly affected in the US, Europe and Japan, and not at all in emerging and developing countries.** All indicators of real growth remained up and steady. The overall losses that a large group of banks might have to write off their (still quite positive) bottom line remained below a reasonably manageable level. There was a destruction of value, but it was well contained to where it belonged, namely the economic operators that had unduly generated ill-managed risks. **The collateral effect on the overall economy was significant, but within tight limits.**

One should bear in mind that, while undergoing a fairly severe liquidity crisis, the world is overflowing with cash, if the big players like sovereign funds are taken into account. There is plenty of liquidity available in the world, but it was not ready to flow through the pipes of a clogged financial system. **This means that the crisis is not about liquidity as such, but hinges from a systemic flaw** that dried out liquidity from where it was most needed.

As a whole, **the crisis was a positive test and a very useful warning against bad practices, lack of professionalism** (a good banker should always know his client, and always be ready and able to tally the risks he is originating), models running out of control (as downstream market people yield the best out of them, far beyond the existing checks and controls from the treasury, banking, monitoring other end of the system: a good banking system should keep both ends closely interconnected, and that relations had unfortunately loosened, if not even spirited off, in the recent years thanks to new financial techniques)

What will matter in the future, and create a major shift in the World economy and society, is **demography, not financial mischief**: 1.5 billion more people will be around in 2020, most of which in developing countries and to a certain extent in America. Europe will shrink and get aged, America's population will still expand but get older too, while India and Japan will keep growing in a fairly balanced way, and China, with the rest of the world, will

grow and get younger. This is what will bring about a revolution in the world's economic structure.

To avoid that shift from creating a rift, we of course ought to keep our good financial system up and operating – we are not going to change it, are we? -, by **drawing lessons from the recent crisis to improve it**, not by getting unwisely scared by the recent shaking, and shocking the system with too many preventive measures. One has also to consider that, were it not for the deflationary effects of Chinese soaring imports, of immigration remits, etc. the overreaction of central banks to a series of small shivers in the economy in the recent years would have unleashed inflation. We ought to remember that **new players**, China, Russia, the Gulf, **are able to pour liquidity in any given market at any time**, and that keeping the system right means more than flooding it with liquidity.

Undergoing such shakes is sound, as soon as you can manage to overcome them and adjust consequently. The world of business relies on risk, not on caution.

But risk has to be priced acutely, and met in a spirit of responsibility.

RISKS AND REMEDIES

BY HERVÉ DE CARMOY

Unfettered finance is reshaping the world economy. Indeed, are we not witnessing a revolution rather than a quiet transformation of the economic and financial scene? What are the inherent dangers of this “brave new financial world”? What should we do to minimize future risks and maximise growth and stability?

THE FACTS

The facts are identified and speak for themselves. Their sheer magnitude creates the novelty. In 2007, according to “Le Monde” (October 2nd, 2007), international reserves amounted to 5.000 billion dollars, 55 times more than in 1973, when the dollar started floating. It is anticipated that in 2007 the reserves of China will increase by about 40%, those of Russia by 65% and those of Brazil by 80%.

The inventory of global financial assets (bank deposits + government debt securities + private debt securities + equity securities) increased from 5 trillion dollars in 1980 to 140 trillion dollars in 2005, or 320% of the world GNP. In the United States financial assets represent over 400% of their GNP. The increase in the depth, breath and sophistication of financial assets has been marked in Europe. Their total reaches around 300% of the European GNP. The UK figure is around 360%. The amount of interest rate and currency swaps and options have now gone up to over 300 trillion dollars (Simon Johnson, 2007). Finally, the annual rate of growth of the world liquidities is hovering around 18%, while interest rates have dropped by over 7% over the last 15 years.

There are many more relevant figures, but these numbers suffice to illustrate the sea-change in the level of world liquidities and financial assets and hence in the complexity and sophistication of their management. Let us now attempt to gain a better understanding of the origin of the present situation.

What are the forces at work, which contribute to this explosion of liquidity and to this diversity in financial instruments?

They have been well analysed:

- First, the *savings glut* generated by the massive increases in the price of oil and other raw materials and by the rapid export oriented industrialisation of developing countries, notably China and India, combined with intensive belt tightening and savings by their populations. In addition, the level of these savings has had a significant impact on the lowering of interest rates.
- Secondly, *science and technology*. There are more engineers in the world today than the sum of all engineers trained between 1770 and 1970. An increasing number of them have been moving into the financial world. They are propagating the revolution of applied mathematics, computing and communications. Their involvement has made possible the almost instantaneous growth of an array of complex transactions, mobilizing huge pockets of money in search of maximum remuneration.

- Thirdly, there is no economic and technological revolution without a concomitant ***change in mentality***. Derivatives, 24 hours trading, new computer based risk management models and pigeon English spread like a pandemic. Why? Because they are easy to learn by a new generation eager to get rich quickly. Real money is today the symbol of personal and social success, especially at a time when future pensions are becoming a black hole,. But the issue goes deeper. In the 21st century, it is unlikely that we will see a class war of the type experienced in the 19th and 20th centuries. It is more probable that we will witness conflicts between generations, as the major source of social tensions. The “Golden Boys” in various areas of finance are a young group, well trained technically, not inhibited by tradition, or status. They communicate mainly between themselves in a sparse language and they are mobile. They are on the opposite end of the mentality of many senior executives. The latter tend to feel that they are part of an establishment. They are seldom inclined to mental mobility; few of them have ever attempted to penetrate the world of these white shirted screen addicts. Only a small number has had the insight to learn sufficiently about modern trading and investment techniques to know what they don’t know and bridge the gap in communication, know how and mentality. This may be one of the causes of today’s problems.
- Saving glut, technology and a new mentality are not sufficient to transform the economic scene and hence the financial landscape. Another factor is at work: ***liberalisation and its corollary, growth in trade.*** One cannot disentangle advances in technology from the emergence of a free global market. Until the 1970’s, the financial industry was highly regulated, notably in the United States. Since then, the Glass Steagle Act was removed and Regulation Q was lifted. In most OECD countries foreign exchange controls have been swept away. Finally the integration of financial markets in Europe has been accelerated since 1999. Together, all of these developments have enabled capitalism to mutate. Large numbers of people around the globe benefit now from simultaneous access to low cost credits and to sophisticated financial products. New players have mushroomed. The number of hedge funds has been multiplied by 15 over 15 years and the estimated value of their assets under management amounts to 1600 billion dollars. The same applies to Private Equity. Their reach encompasses thousand of companies of all size around the world. They have raised, in 2006, over 430 billion dollars in commitments.
- What is the end result for the world economy of all of these factors at work almost concomitantly? Clearly it is highly positive.*** It can be said that the world has been going through a kind of Golden Age, in spite of numerous big blows: The Asian financial crisis, the dot.com boom and bust, the sharp increases in the price of oil, 9/11, wars in Afghanistan and Iraq, all of these shocks have been absorbed without disturbing economic growth and stability. The world economies have indeed become better at taking stresses and strains. Why? Because they have become more flexible. Greater sophistication in the conduct of monetary policies (including the emergence of a competent European Central Bank), improvements in the management of stocks and goods (generalisation of “just in time” practices), expansion of the credit markets through higher liquidities and lower interest rates, as well as financial innovations have contributed to 35 years of world economic expansion at a rate of growth of 4/5% per annum. At the same time the rate of inflation has come down significantly. .

However, recent events suggest that the Golden Age may be tested through converging shocks. The learning curve towards durable prosperity is steep indeed.: Discord in the credit market, vulnerability in some of the housing markets, opacity in the financial markets, could lead to troubles in the rich world economies, which in turn could reverberate globally. Let us review the majors risks behind today's' turmoil.

THE RISKS

. One needs not be a prophet of doomsday to recognise that major dangers have already emerged in a number of areas. Figures speak for themselves: the September 2007 report of the IMF mentions, for the United States, a potential write off of 170 billion dollars of which a 130 billion dollar loss by the American banking system alone. This does not include losses in Europe and else where Amounts of that magnitude require that various types of risks materialize in a converging way. What are they?

1. INFORMATION TECHNOLOGY (IT)

The first question to ask is whether IT developments used to insure the fluidity of the financial markets are secured. The answer is mixed. The number of announced vulnerabilities in computing platforms has been rising exponentially. There is no particular guarantee on the authenticity of many of the new financial screens available via the Internet, on the integrity of the data one is reading, as being accurate in real time. Many of these sites that freely provide market data are not even protected by rudimentary Secure Socket Layer encryption, on every page deployed.

2. CREDIT RISKS AND RISKS OF MARKET VALUATION

Who can deny that the trust in the digital world is more difficult to sustain. Often, investors appear opaque. There seems to be a permanent shift to new power brokers. 10 years ago they were little more than "fringe players". Today powerful States back investors, such as petrodollar investors and Asian Central Banks, new rich individuals, are becoming major actors, willing to take risks, without much emphasis on transparency and governance? Often they have little knowledge of each other. One cannot count on time honoured trust building measures such as personal proximity and physical contacts. In addition, disciplined credit processes have been relaxed notably in real estate and in financial markets. It coincides with the under-pricing of risk almost across every asset class over the last few years. For cost cutting considerations, the credit department of many experienced institutions have been understaffed, if not downsized, while the sale side has been expanded. So the majority of decision makers rely heavily on screens and on rating agencies. The latter phenomenon is recent.

Until the end of the 1980's, *rating agencies* were hardly relevant to the good functioning of the world capital markets except for issuers like local governments. At that time, long-term syndicate loans represented 55% of international lending. Since then the world has undergone a mutation. Pension funds and other institutional investors have demanded higher yield investments. They have encouraged the growth of innovative financing instruments based on mathematical modelling: it was nicknamed "mark to model". From that time onwards, large and smaller financial institutions securitised a significant portion of their loan books and relied on fees rather than on interest rate margins for structuring and issuing new debt obligations. They used rocket scientists to conceive state of the art financial products.

Unfortunately most of these whiz kids had little knowledge of Black Monday, LTCM or of the breakdown in communication created by 9/11. The majority of the model builders had no memory of past near-disasters and most of the high up supervisors did not possess the mathematical and technical skills to control and interface with the model builders. The same disfunctioning applied to rating agencies. They did not have sufficient in-house capabilities to rate with reliability several thousand hedge funds and investment boutiques, many of which looked like black boxes.

These deficiencies may have been at the root of the present liquidity crisis. The magnitude of the problem has been made worse by several malpractices. A number of issuers invited the rating agencies to supply advisors into the process of designing innovative debt products (CDO-CLO). But, what is more, issuers of CDO's retained the ability to "engineer" the product depending upon market circumstances. The icing on the cake was provided by many funds asking their own head of trading to prepare monthly valuations of the performance of their products and funds, rather than use in-house or external independent auditors.

All of these malpractices highlight the flawed process of corporate governance first and foremost within many financial institutions and to some extent within rating agencies. The rating agencies did step up their disclaimers, but not to the extent of the tobacco industry. Hence users did not realize sufficiently that ratings alone were simply not relevant for market valuations. They mention it in their small print. To no avail: they were not listened to. Investors in fact had few alternatives for valuation given the opaqueness of the mathematical model behind the debt obligation. A handful of them understood the technical underpinning of option pricing as developed by Myron Scholes and Fisher Black, thirty years ago.

In reality control and monitoring of the credit and market risks became diluted at three levels: regulators were requested by politicians and by the industry to dismantle many of the regulations in force decades ago. Few of them took the initiative to rewrite regulations drafted at that time for an entirely different risk profile. The Basel procedures and regulations may have had too narrow a focus. They may not have sufficiently taken into account financial innovations. The environment changed more rapidly than the practices of sound governance. National Central Banks may not have had the clout and the resources to examine lending and investing practices of all subsidiaries and affiliates around the world of the institutions headquartered in their country. In addition, many pension funds, banks, insurance companies, hedge funds and mutual funds bought, held, and divested financial assets, based on external ratings rather than on an intimate in-house knowledge of the financial products engineered and manufactured externally. Rating agencies were largely in the same situation. They may not have developed to the extent needed the expensive trading and computer skills necessary to assess both market risks, liquidity risks and probability of default. Finally, ad hoc boutiques for managing money and trading mushroomed in many places, without much supervision from financial institutions or regulators, notably in tax heavens. This is an area of distinct concern, for the worldwide framework of international cooperation in financial regulation and monitoring of new financial risks, may still leave something to be desired.

However, it is not the first time that a crisis happens. History is full of them. In the 1960's the Chase Manhattan Bank created one of the first REIT for an amount of 500 million dollars, the equivalent of over 5000M\$ of today's money. Major investment mistakes were made which lead to the closure of the Trust. Confronted with a potential serious liquidity problem, Chase took four decisions: It negotiated immediately a five year stand –by for 500M\$; it transferred to its own books all of the "sub-prime" real estate assets, that had accumulated in the REIT.

To protect its own liquidity, Chase froze most of the in-house lending for about nine months. Since, as young credit officers, we had, for a while, little to do except to slow down drawings under existing commitments, we were asked to help design and draft a new manual of credit control and to cost its introduction and use. We figured out that it would represent about .3% of the bank's margin on its new lending.

3. INCREASE IN LIQUIDITY AND RISK OF ECONOMIC INSTABILITY

We are entering here an area opened for debate even among economists. Is there any link between massive increases in liquidity and potential inflation and economic instability? Some link probably exists but there are other parameters that come into play. What can be said is that the sheer size and the asymmetry of the new liquidities around the world could generate, at some point in time, disorderly unwinding of global financial unbalances. This issue deserves careful expert investigation, especially in the light of the experience gathered with the present financial crisis. In retrospect, what does it teach us? One point is at least uncontroversial! We all need to go back to basics: *There is a risk of corporate annihilation when financial institutions fund their medium term assets, often difficult to evaluate and partially illiquid, with short-term commercial paper.*

In addition, the nature and scope of the credit/liquidity risk may become harder to quantify for any outsider. Securitisation has enabled financial institutions to do a two step dance: lay off credits which they generate on their books, often of good quality, while purchasing for their own account securities that entail other types of credit risks and higher remuneration. Few people inside these institutions, and even more so outside, will actually apprehend with accuracy the net-net exposure of financial firms that constantly change the composition of their risk assets on their books. Name lending becomes then the rule of the game, until such times as the reputations risks become a balance sheet/ liquidity risk. Obviously all of these risks are heightened by the growth of leverage. Three years ago, good quality Private Equity deals was made at leverage ratios of 3-4 to 1. In the first semester of 2007, the leverage ratio reached 7-9 to 1, if not more. As a result of the change in environment, many institutions have developed a heightened perception of counterparty exposure. Today, more than ever, cash is king and it commands a premium. This premium is apparent in the present rates/spreads of inter-bank borrowings as well as in the fire sales at deep discounts of various types of financial assets by institutions experiencing a liquidity squeeze.

4. POLITICAL RISKS

The growth of the importance of finance is likely to remain a permanent fixture of the 21st century. Yet, it is becoming clear that financial capitalism creates social and political stresses. Within many countries, relationships of power are changing and coalitions are developing to curb the impact of emerging players. The "new money", notably in the form of Private Equity, is challenging incumbent managers and affecting ordinary people. Few of them realize the value to themselves of radical changes in the way companies are run, when in the hands of Private Equity firms. They feel threatened by a profit-seeking machine beyond their understanding and control.

*On a global basis the political equation is made difficult by the **income shift**, from labour to capital. People's perception is that the combination of highly incentivised managers, with their profit sharing and option schemes, together with an immense pool of uneducated and partially educated labour force from China, India, and other developing countries, creates a*

situation of “win all, take all”. The vast multitude of low wage and middle-income earners tend to have their remuneration stagnate, if not decline. They resent it all the more so as they do not comprehend the link between the new process of wealth creation, which probably saved their job and the disparity of income. Envy becomes a significant factor. The Golden Boys and the senior managers earn a multiple of the average employee’s wages. The difference in remuneration between the top and the bottom of the pyramid has grown over the last 15 years from 85 to 500 to 1. It could become a political issue.

There is also another political issue of great potency: ***Sovereign Wealth Funds (SWFs)*** from Middle Eastern countries, Russia, Central Asia, China and India have at their finger tips 2,8 trillions of dollars of liquid assets (“Le Monde”, October 2nd, 2007), part of which could be used to make hostile takeover bids of private national champions. *Can major countries accept to have the decisions centres of such groups move to areas of the world that do not share their vision of democracy, of law and order and of national and/or regional interest? Will it be acceptable to their constituencies? Could such takeovers have a damaging social and security impact and how does one deal effectively with these SWFs?* There is a need, probably with the help of Central Banks and of investment banks, to investigate and become more familiar with the staff and policies of these sovereign funds, with their corporate vision, their strategy and values in order to elaborate common rules of the game beneficial to all parties. The success of Mittal Steel in Europe illustrates a way forward that yields mutual benefits.

At this point, it is time to emphasise that each and every one of *the above mentioned risk categories are manageable*. Addressing them requires a concerted effort at various levels: Central Banks, financial regulators, International Financial Institutions, rating agencies, auditors, banks, funds, and insurance companies. They all have to alter their focus, step up their in-house control and consulting capacity and improve their own internal processes. Forty- five years ago, “go-go” banking was stigmatised. Half a century later there is a need to rediscover the virtues of modern professionalism in all areas of finance, which may imply, in some cases, inflicting distress and letting inefficient players disappear from the scene.

THE REMEDIES

Present turbulences reflect first and foremost the lack of transparency within many institutions, and the benign neglect with which credit risks were generated and assumed.

Too little is known at every level of responsibility and authority, in the financial world, about the practices of new players and about the way complex products are constructed, valued, managed, financed and transferred to counterparties. The same ***deficiency of information and risk focus*** applies to our understanding of the links and ramifications between significant financial institutions and a multitude of satellite funds and vehicles operating within their constellation. Some of these new entities are partially owned by good names, managed by teams that have worked in their trading rooms. Thus they can negotiate more easily money market facilities. Control exercised over their activities is often scant.

There are many ways to respond effectively to this situation. Financial players must henceforth invest heavily in ***internal controls***. The control function should be represented at the executive committee level of most financial institutions. It should act as an effective countervailing power to the sale and trading side. It should work hand in hand with the human resources function when the time comes to develop the proper mechanisms for incentives.

The potential credit and liquidity risks, notably those associated with mathematical modelling, should be properly communicated to most concerned managers in the company. Finally, if major losses occur senior management should be held accountable and not only members of the trading room.

It used to be said, “Good industry produces good finance”. The two sides of the coin are today inseparable. They are both engines of growth and development. Who can deny that active financial investors spot and correct pockets of inefficiency? They impose different management teams and disciplines, finance new activities and put traditional industries into the hands of better performers. As a result, at all levels, consumers and investors are better off. But there is one *caveat*: ***the new regulatory and governance challenges must be met with determination.***

The speed and depth, at which changes will take place, could become the decisive factor in the continuation of the “Golden Decades”. All of the participants in the world of Finance have the winning cards in their hands to achieve durable growth for all stakeholders.

ANNEXES

P R O G R A M M E

FRIDAY 26TH OCTOBER

15h00: Opening of Conference Secretariat at InterContinental Hotel (Room “Vivaldi” I-II)

16h30: *European ExCom Meeting (InterContinental Hotel, “Mozart” Room)*

19h30: *Opening Reception & dinner in the Konzerthaus*

Karel Schwarzenberg
Minister of Foreign Affairs, Czech Republic

SATURDAY 27TH OCTOBER

Haus der Industrie

SESSION I: AUSTRIA
09h00-10h30

Chaired by Guido Schmidt-Chiari, Chairman, Austrian Group

Alfred Gusenbauer, Federal Chancellor
Martin Bartenstein, Federal Minister of Economics and Labour
Andreas Treichl, Chairman & CEO, Erste Bank

SESSION II: FUTURE PROSPECTS FOR THE WEST BALKANS AND/IN THE EU
10h45-13h00

Chaired by Andrzej Olechowski, European Deputy Chairman

SETTING THE BALKANS SCENE: **Tim Judah**, Independent Journalist & Balkan Correspondent, “The Economist”, London

STATE OF THE EU/US/RUSSIA “TROIKA” NEGOTIATIONS ON KOSOVO: **Wolfgang Ischinger**, EU Member of Troika and German Ambassador to the UK

KOSOVO: **Veton Surroi**, Member, Kosovo Assembly; Head, ORA Reformist Party; Publisher, “Koha Ditore”, Pristina

SERBIA: **Goran Slivanovic**, Former Foreign Minister; Chair WT I on Democratisation & Human Rights, SE European Stability Pact, Belgrade

BOSNIA-HERZEGOVINA: **Miroslav Lajcak**⁵, High Representative/EU Special Representative, Sarajevo

⁵ Cancelled on October 26th

(Saturday, October 27th cont.)

Luncheon **THE ORGANISATION FOR SECURITY & COOPERATION IN EUROPE**

13h00-14h30

(Haus der Industrie) **Marc Perrin de Brichambaut**, Secretary General, OSCE, Vienna

SESSION III: **TOPICAL SESSION ON THE EU: THE FINANCIAL SCENE**

14h30-17h00

FROM A SURGE IN GLOBAL LIQUIDITIES TO CREDIT CRUNCH

*Chaired & moderated by **Hervé de Carmoy**, European Deputy Chairman*

Lucas Papademos, Vice President, European Central Bank, Frankfurt/Main;
Former Governor, Central Bank of Greece

Jacob A. Frenkel, Vice Chairman, American International Group (AIG);
Chairman, Group of Thirty (G-30); Former Governor of
the Bank of Israel

Alessandro Profumo, Chief Executive Officer, UniCredit Group, Milan

Nout Wellink, Governor of the Central Bank of The Netherlands, Amsterdam

Rudi Bogni, Director of Old Mutual and Prospect Publishing, and Chairman of
The International Advisory Board of *Oxford Analytica*;
Former Chief Executive of Private Banking for UBS

19h30-

Reception & Dinner at the Palais Museum Liechtenstein

Ursula Plassnik

Federal Minister for European and International Affairs, Austria

SUNDAY 28TH OCTOBER

InterContinental Hotel

SESSION IV:

A RESURGENT RUSSIA AND EUROPE

09h00-12h30

*Chaired by **Peter Sutherland**, European Chairman*

“ENGAGING WITH RUSSIA: NEXT STEPS”

Presentation/moderated by: **Sir Roderic Lyne**, Former British Ambassador to the Russian
Federation, London

Russia “Respondent”:
Sergei Karaganov, Dean of the School of World Economics and
International Affairs of the State University–Higher
School of Economics; Chairman of the Presidium of
Council on Foreign and Defense Policy; Chairman of the
Editorial Board of “Russia in Global Affairs”, Moscow

U.S. “Respondent”:
Robert D. Blackwill, President, Barbour Griffith & Rogers
International, Washington; Former U.S. Ambassador &
Member of the National Security Council

LIST OF PARTICIPANTS

- (*) Executive Committee Member
(**) Triennium Participant from other Areas
(***) Former Member in Public Service
(s) with Spouse

EUROPEAN MEMBERS & “TRIENNIUM PARTICIPANTS”

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- Jacques Andréani (s)**
Ambassadeur de France, Paris; former Ambassador to the United States; *spouse: Donatella Andréani*
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Editor-in-Chief, *Polityka*, Warsaw
- Estela Barbot**
Director, AGA; Director, Bank Santander Negocios; Member of the General Council, AEP -- Portuguese Business Association, Porto; General Honorary Consul of Guatemala, Lisbon
- Marek Belka**
Executive Secretary, United Nations Economic Commission for Europe (UNECE), Geneva; former Prime Minister and Minister of Finance of Poland, Warsaw; former Ambassador-at-Large and Chairman, Council for International Coordination, Coalition Provisional Authority, Baghdad
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Chairman of the Executive Board, Lhoist Group, Limelette, Belgium; *spouse: Baroness Katherine Berghmans*
- Nicolas Beytout**

Editor, *Le Figaro*, Paris; former Editor, *Les Echos*, Paris

Manfred Bischoff

Chairman of the Supervisory Board, DaimlerChrysler, Munich; former Member of the Board of Management, DaimlerChrysler AG; former Chairman, EADS

Jean-Louis Bruguière

Judge; former First Magistrate and First Vice President of the Paris County Court in charge of the anti-terrorist section

***François Bujon de l'Estang (s)**

Ambassadeur de France; Chairman, Citigroup France, Paris; former Ambassador to the United States; *spouse: Anne Bujon de l'Estang*

Sven Burmester (s)

Writer and Explorer, Denmark; former Representative, United Nations Population Fund (UNFPA), Beijing; former World Bank Deputy Secretary and Representative in Cairo; *spouse: Janet Burmester*

Salvatore Carrubba

Director of Strategies and Columnist, *Il Sole 24 Ore*, Milan; former Culture Alderman, Municipality of Milan

Jürgen Chrobog

Chairman, BMW Herbert Quandt Foundation, Munich; former German Deputy Foreign Minister and Ambassador to the United States

***Richard Conroy**

Chairman, Conroy Diamonds & Gold, Dublin; Member of Senate, Republic of Ireland

Eduardo Costa

Executive Vice Chairman, Banco Finantia, Lisbon; Member, Forum Portugal Global

Enrico Tomaso Cucchiani

Member of the Board of Management, Allianz SE, Munich; Chief Executive Officer, Allianz S.p.A., Trieste

***Vladimir Dlouhy (s)**

Senior Advisor, ABB; International Advisor, Goldman Sachs; former Czechoslovak Minister of Economy; former Czech Minister of Industry & Trade, Prague; *spouse: Eliska Brizova*

****Hüsnü Dogan (s)**

General Coordinator, Nurol Holding; former Chairman of the Board of Trustees, Development Foundation of Turkey; former Minister of Defence, Ankara, Turkey; *spouse: Sefika Dogan*

***Bill Emmott**

Former Editor, *The Economist*, London

***Nemesio Fernandez-Cuesta (s)**

Executive Director of Upstream, Repsol-YPF; former Chairman, Prensa Española, Madrid; *spouse: Gloria Fernandez-Cuesta*

Jürgen Fitschen (s)

Member of the Group Executive Committee, Deutsche Bank, Frankfurt-am-Main; *spouse: Friederike Lohse*

Klaus-Dieter Frankenberger

Foreign Editor, *Frankfurter Allgemeine Zeitung*, Frankfurt am Main

****Jacob Frenkel (s)**

Vice Chairman, American International Group, Inc. (AIG) & Chairman, AIG's Global Economic Strategies Group, New York; Chairman, Group of Thirty (G-30); former Chairman, Merrill Lynch International, London; former Governor, Bank of Israel; *spouse: Iris Lavy*

Louise Fresco

University Professor, University of Amsterdam; Member of the Board of non-executive Directors, RABO Bank, Utrecht; former [Assistant Director-General](#), Head of Agriculture Department, [Food and Agriculture Organization of the United Nations in Rome](#)

Hugh Friel (s)

Chief Executive, Kerry Group, Tralee, Co. Kerry, Ireland; *spouse: Olive Friel*

Lykke Friis (s)

Pro-Rector, University of Copenhagen; *spouse: Peter Friis*

***Michael Fuchs**

Member of the German Bundestag, Berlin; former President, National Federation of German Wholesale & Foreign Trade

Lord Garel-Jones

Managing Director, UBS Investment Bank, London; Member of the House of Lords; former Minister of State at the Foreign Office (European Affairs)

Wolfgang Gerhardt (s)

Member of the German Bundestag; Chairman of the Friedrich-Naumann Foundation; former Chairman of the Free Democratic Party, Berlin; *spouse: Marlies Gerhardt*

Lord Gilbert (s)

Member of the House of Lords; former Minister for Defence, London;
spouse: Lady Jean Gilbert

General The Lord Guthrie (s)

Director, N M Rothschild & Sons, London; Member of the House of Lords; former Chief of the Defence Staff, London; *spouse: Lady Kate Guthrie*

Antti Herlin

Chairman of the Board, Kone Oyj, Helsinki

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Honorary Chairman, Solvay, Brussels; *spouse: Baroness Thérèse Janssen*

***Béla Kadar**, Member of the Hungarian Academy, Budapest; Member of the Monetary Council of the National Bank; President of the Hungarian Economic Association; Former Ambassador of Hungary to the O.E.C.D., Paris; former Hungarian Minister of International Economic Relations and Member of Parliament

****Sergei Karaganov (s)**

Dean of the School of World Economics and International Affairs of the State University–Higher School of Economics; Chairman of the Presidium of the Council on Foreign and Defense Policy; Chairman of the Editorial Board of “Russia in Global Affairs”, Moscow; *spouse: Ekaterina Karaganova*

Robert Kassai (s)

General Vice President, The National Association of Craftmen’s Corporations, Budapest; *spouse: Erzsébet Csongradi*

***Lord Kerr of Kinlochard (s)**

Deputy Chairman and Senior Independent Non-executive Director of Royal Dutch Shell; Member of the House of Lords; Director of Rio Tinto, the Scottish American Investment Trust, London; former Secretary General, European Convention, Brussels; former Permanent Under-Secretary of State and Head of the Diplomatic Service, Foreign & Commonwealth Office, London; former British Ambassador to the United States;
spouse: Lady Elizabeth Kerr

Gabor Kovacs (s)

Chairman and Chief Executive Officer, Bankar Holding; Founder, KOGART (the Kovacs Gabor Art Foundation), Budapest; *spouse: Timea Kalmar*

Ivan Krastev

Chairman of the Board and Programme Director for Political Research, Centre for Liberal Strategies, Sofia; Editor-in-Chief, Bulgarian Edition, *Foreign Policy*

Ulysses Kyriacopoulos (s)

Chairman, S&B Group; former Chairman, Federation of Greek Industries, Athens;
spouse: Nicole Kyriacopoulos

Kurt Lauk

Member of the European Parliament (EPP Group-CDU); Chairman, Globe Capital Partners, Stuttgart; President, Economic Council of the CDU Party, Berlin; Former Member of the Board, DaimlerChrysler, Stuttgart

Thomas Leysen

Chief Executive Officer, Umicore, Brussels

***Marianne Lie (s)**

Director General, Norwegian Shipowner's Association, Oslo; *spouse: Bertil Tiusanen*

Francis Maude (s)

Member of the British Parliament; Chairman of the Conservative Party; Director, Benfield Group; former Shadow Foreign Secretary, London; *spouse: Christina Maude*

Friedrich Merz

Member of the German Bundestag; former Member of the European Parliament; former Chairman of the Parliamentary Group of the CDU/CSU in the Bundestag, Berlin

Peter Mitterbauer (s)

Honorary President, The Federation of Austrian Industry, Vienna; President and Chief Executive Officer, Miba, Laakirchen; *spouse: Waltraud Mitterbauer*

Sir Mark Moody-Stuart (s)

Chairman, The Global Business Coalition on HIV/AIDS, Tuberculosis and Malaria; Chairman, Anglo American; former Chairman, Royal Dutch/Shell Group, London; *spouse: Lady Judy Moody-Stuart*

Ewald Nowotny (s)

Chief Executive Officer, BAWAG P.S.K., Vienna; *spouse: Ingrid Nowotny*

Arend Oetker

President, German Council on Foreign Relations (DGAP); Vice Chairman, Federation of German Industries; Managing Director, Dr. Arend Oetker Holding, Berlin

Richard Olver (s)

Chairman, BAE Systems, London; *spouse: Pamela Olver*

Dimitry Panitza (s)

Founding Chairman, The Free and Democratic Bulgaria Foundation; Founder and Chairman, The Bulgarian School of Politics, Sofia; *spouse: Yvonne Panitza*

Lucas Papademos

Vice President, European Central Bank, Frankfurt-am-Main; former Governor of the Bank of Greece

Volker Perthes

Director, SWP (German Institute for International and Security Affairs), Berlin

Dieter Pfundt (s)

Personally Liable Partner, Sal. Oppenheim Bank, Frankfurt-am-Main; *spouse: Heide Teschner-Pfundt*

Alessandro Profumo

Chief Executive Officer, UniCredit Group, Milan

****Itamar Rabinovich (s)**

Ettinger Chair of Contemporary Middle Eastern History, Tel Aviv University, Israel; Charles and Andrea Bronfman Distinguished Fellow at the Saban Center, Brookings Institution; Distinguished Global Professor at New York University; Visiting Professor at the Kennedy School of Government at Harvard University; former Ambassador to the United States; *spouse: Efrat Rabinovich*

Wanda Rapaczynska

President of the Management Board, Agora, Warsaw

H. Onno Ruding (s)

Chairman, Centre for European Policy Studies (CEPS), Brussels; Former Vice Chairman, Citibank; former Dutch Minister of Finance; *spouse: Renée Ruding*

Ferdinando Salleo (s)

Vice Chairman, MCC (Mediocredito Centrale), Rome; former Ambassador to the United States; *spouse: Anna Maria Salleo*

****Rüsdü Saracoglu (s)**

President of the Finance Group, Koç Holding; Chairman, Makro Consulting, Istanbul; former State Minister and Member of the Turkish Parliament; former Governor of the Central Bank of Turkey; *spouse: Nurdan Saracoglu*

***Guido Schmidt-Chiari (s)**

Chairman of the Supervisory Board, Constantia Group; former Chairman, Creditanstalt Bankverein, Vienna; *spouse: Stephanie Schmidt-Chiari*

Henning Schulte-Noelle (s)

Chairman of the Supervisory Board and former Chief Executive Officer, Allianz, Munich;

Spouse: Renate Schulte-Noelle

Karel Schwarzenberg

Minister of Foreign Affairs; Founder and Director, Nadace Bohemiae, Prague; former Member of the Czech Senate; former Chancellor to President Havel; former President of the International Helsinki Federation for Human Rights

***Carlo Secchi,**

Professor of European Economic Policy and former Rector, Bocconi University; Vice President, ISPI, Milan; former Member of the Italian Senate and of the European Parliament

Slawomir S. Sikora

Chief Executive Officer and Citigroup Country Officer for Poland, Bank Handlowy w Warszawie, Warsaw

Stefano Silvestri (s)

President, Institute for International Affairs (IAI), Rome; Commentator, *Il Sole 24 Ore*; former Under Secretary of State for Defence, Italy; *spouse: Marie-Christine Silvestri*

***Petar Stoyanov (s)**

Former President of the Republic of Bulgaria; Member of Bulgarian Parliament; Chairman of Parliamentary Group of United Democratic Forces; Chairman of Union of Democratic Forces, Sofia; *spouse: Antonina Stoyanova*

Peter Straarup (s)

Chairman of the Executive Board, Danske Bank, Copenhagen; Chairman, the Danish Bankers Association; *spouse: Rickie Straarup*

Lady Barbara Thomas Judge

Chairman, UKAEA (United Kingdom Atomic Energy Authority); former US Securities Exchange Commissioner

***Harri Tiido (s)**

Undersecretary for Political Affairs, Estonian Ministry of Foreign Affairs, Tallinn; former Ambassador of Estonia and Head of the Estonian Mission to NATO; *spouse: Anna Tiido*

Andreas Treichl (s)

Chairman and Chief Executive Officer, Erste Bank der Oesterreichischen Sparkassen, Vienna; *spouse: Désirée Treichl*

Elsbeth Tronstad (s)

Executive Director, Confederation of Norwegian Enterprise (NHO); former Vice President, ABB, Oslo; *spouse: Björn-Erik Lonn*

Janne Virkkunen

Senior Editor-in-Chief, *Helsingin Sanomat*, Helsinki

*****Karsten D. Voigt**, Coordinator of German-American Cooperation, Federal Foreign Ministry, Berlin

Joris Voorhoeve

Member of the Council of State; former Member of the Dutch Parliament; former Minister of Defence, The Hague

***Panagis Vourloumis (s)**

Chairman and Chief Executive Officer, Hellenic Telecommunications Organization (O.T.E.), Athens; *spouse: Ediana Vourloumis*

***Serge Weinberg**

Chairman of the Supervisory Board, Accor; Chairman and Chief Executive Officer, Weinberg Capital Partners; former Chairman of the Management Board, Pinault-Printemps-Redoute; former President, Institute of International and Strategic Studies (IRIS), Paris

***Heinrich Weiss (s)**

Chairman, SMS, Düsseldorf; former Chairman, Federation of German Industries, Berlin; *spouse:*
Susan Weiss

Nout Wellink

President, Dutch Central Bank, Amsterdam

GUEST SPEAKERS

Martin Bartenstein

Federal Minister of Economics and Labour, Austria

Robert D. Blackwill

President, Barbour Griffith & Rogers International, Washington; former U.S. Ambassador & Member of the National Security Council; North American Trilateral Commission Member

Rudi Bogni (s)

Director of Old Mutual and Prospect Publishing, and Chairman of the International Advisory Board of *Oxford Analytica*; Former Chief Executive of Private Banking for UBS;
spouse: Florence Bogni

Alfred Gusenbauer

Federal Chancellor, Austria

Wolfgang Ischinger (s)

European Member of the Troïka on the Kosovo Status Determination and German Ambassador to the United Kingdom; *spouse: Jutta Ischinger*

Tim Judah (s)

Independent Journalist & Balkan Correspondent, *The Economist*, London;
spouse: Rosie Judah

Miroslav Lajcak

High Representative/EU Special Representative, Sarajevo

Sir Roderic Lyne (s)

Former British Ambassador to the Russian Federation; *spouse: Lady Mandy Lyne*

Marc Perrin de Brichambaut

Secretary General, OSCE, Vienna

Ursula Plassnik

Federal Minister for European and International Affairs, Austria

Goran Slivanovic

Former Foreign Minister of Serbia Montenegro; Chair WT I on Democratisation & Human Rights, SE European Stability Pact, Belgrade

Veton Surroi

Member, Kosovo Assembly; Head, ORA Reformist Party; Publisher, *Koha Ditore*, Pristina

GUESTS

Uzi Arad

Head, Institute for Policy and Strategy, Lauder School of Government, Diplomacy and Strategy; Chair, *The Herzliya Conference Series*, Israel

Nani Beccalli-Falco

President & Chief Executive Officer, GE International, Brussels; North American Trilateral Commission Member

Peter Goldscheider

Chairman, EPIC, Vienna

Charles Grant

Director, Centre for European Reform, London

Jan Homan

Chief Executive Officer, Teich AG, Austria

Theresa Jordis

Lawyer, Dorda, Brugger & Jordis, Vienna

Veronika Kickinger

Oesterreichische Post AG, Vienna

Michele Luzi

Partner, Bain & Company, London

Edgar Meister (s)

Member of the Board, Deutsche Bundesbank, Frankfurt-am-Main; Chairman, the Banking Supervisory Subcommittee of the European Monetary Institute (EMI); Chairman, the Banking Supervision Committee of the European System of the Central Banks (ESCB); *spouse: Helga Meister*

Giles Merritt (s)

Secretary General, Friends of Europe, Brussels; *spouse: Brigid Grauman*

Ivan Miklos

Member of the National Council of the Slovak Republic (Parliament); Former Deputy Prime and Minister of Finance & Economic Affairs, Bratislava

Thomas Oberreiter

Chief of Cabinet of the Federal Minister for European and International Affairs, Austria

Michael O'Neil (s)

North American Director, The Trilateral Commission; Partner, Preston Gates Ellis & Rouvelas Meeds, Washington ; Former Legal Counsel of the CIA; *spouse: P.A. O'Neil*

William Pfaff (s)

International Columnist, Paris; *spouse: Carolyn Pfaff*

Wim Philippa

Secretary General, European Round Table of Industrialists (ERT), Brussels

Heinz Riesenhuber (s)

Member, German Bundestag; former Federal Minister of Research & Technology, Berlin; Chairman, Supervisory Boards, Kabel Deutschland & Evotec; *spouse: Beatrix Riesenhuber*

Friedrich Roedler (s)

Price Waterhouse, Vienna; *spouse: Maria Bergmini-Roedler*

Beda Romano,

Correspondent, *Il Sole-24 Ore*, Frankfurt-am-Main

Helene Schuberth

Office of the Federal Chancellor, Austria

Tobby Simon

Chief Executive Officer, SYNERGIA (Business Beyond Borders), Bangalore, India

Baron Bernard Snoy (s)

Co-ordinator, OSCE Economic and Environmental Activities, Vienna;
spouse: Baroness Christine Snoy

Myles Staunton (s)

Former Member of the Irish Senate & of the Dail; Consultant, Westport, Co. Mayo;
spouse: Marianne Staunton

Gabriele Stöffler

Office of the Federal Minister of Economics and Labour, Austria

Tomas Szunyog

Director of South Eastern and Eastern Europe Department, Ministry of Foreign Affairs of the Czech Republic

Niels Thygesen (s)

Danske Bank Professor of International Economics, University of Copenhagen; Chairman, OECD Economic Development and Review Committee; Chairman, MTS, Copenhagen;
spouse: Irene Thygesen

Mary Valder

Executive Assistant of the North American Director, The Trilateral Commission, Washington

Georg Winckler

Rector of the University, Vienna

EUROPEAN OFFICE

Paul Révay

European Director, The Trilateral Commission, Paris

Karine Fargier

Assistant to the European Director, The Trilateral Commission, Paris

NATIONAL GROUP SECRETARIES

Ernesto Vellano (s)

Secretary-Treasurer, Italian Group of the Trilateral Commission; Chairman, SGN S.p.A., Turin;
spouse: Pierangela Vellano

Bernhard May (s)

Secretary-Treasurer, German Group of the Trilateral Commission, Berlin
spouse: Beate May

Frédéric de Castro (s)

Secretary-Treasurer, French Group of the Trilateral Commission; Director of Finance, Rexel Group, Paris; *spouse: Aymée de Castro*

AUSTRIAN CONFERENCE OFFICE

Brigitte Koudela

Assistant to the Chairman of the Austrian Group of the Trilateral Commission, Vienna

Elisabeth Huimann

Group Strategy/International Events, Erste Bank, Vienna

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