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"THE END OF AN ERA IN EURASIA?  
CONFLICT IN EASTERN UKRAINE AND ECONOMIC DOWNTURN  
IN THE POST SOVIET SPACE"

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IN MEMORIAM  
ZSUZSA LUDVIG



**LUDVIG, ZSUZSA (1964-2014)**



## IN MEMORIAM ZSUZSA LUDVIG

It was always a kind of challenge to study Russia or the former Soviet Union. It has never been a popular topic in Hungary. An old joke concerning three key differences between the Turkish occupation (1541-1686) and the temporary military presence of the Soviet Union in Hungary (1945-1990) explained why the Turks were able to stay longer. The first reason was that Turks did not seek to compel Hungarians to learn Turkish in primary school. The second was that they did not require Hungarians to celebrate the anniversaries of the Mohács Battle (when Turkish troops badly routed Hungarian forces in 1526). And the last, but maybe most important, difference was that Turkish rulers never promised that they would stay only temporarily. The Soviet Union was therefore not really popular among young researchers of the 1980s, and this attitude carried over in perceptions of Russia in the 1990s as well.

Some daring young fellows thought that it would perhaps be wiser to keep using and maintaining their Russian language skills once they had mastered the language, and thus they continued studying Russian (Soviet) society, culture and economy. These studies gave them access to a magic world of sorts! Those who did not allow negative preconceptions to determine their attitude and remained open to the impact of a great culture were rewarded with exceptional gifts: masterpieces of arts, original and exciting ways of thinking, and friendships with open-hearted and open-minded colleagues. They learned to view the world from the (Soviet) Russian perspective as well, which provided them with a better understanding of the forces that drive the world economy and politics. The knowledge of this insider view is a precondition for the proper understanding of economic, political and social processes in any country.

Zsuzsa Ludvig was one such daring fellow. She studied Russian culture extensively and developed strong friendly ties to many Russian researchers. She also expanded her research interest to other post-Soviet states. Based on her accumulated local knowledge, she was able to understand and analyze economic and social progress in very comprehensive ways. She became one of the most renowned Hungarian experts of the post-Soviet region. Her research results were disseminated among members of the research community in several books and other publications.

I am not an expert on the post-Soviet countries, but I am aware that comparisons between that region and Central Europe require a certain amount of knowledge. My

cooperation with Zsuzsa was based on her explaining to me many of the details and drivers of current Russian economy and politics. I could always rely on her knowledge and information.

We also spent some time together at conferences and study trips in Russia, where we visited colleagues and friends. I would like to mention especially the Institute of Economics of the Russian Academy of Sciences, and our good friend there, Ms. Svetlana Glinkina. We visited her several times and also invited Ms. Glinkina and her colleagues to Hungary. These visits and meetings were always very special, for they allowed us to discuss the most serious topics in a friendly atmosphere, and also provided us with the opportunity to share many wonderful hours at interesting places and events both in Russia and in Hungary.

Zsuzsa was deeply convinced that personal contacts could play a key role in achieving better understanding between peoples and nations. She worked much on establishing, supporting and improving the networks between Russian and Hungarian researchers. Her passing was a major loss for the international research community.

*Miklós Szanyi*



## ZSUZSA LUDVIG AS A RESEARCHER AND AS A PERSON

It was just after the Fall of Communism, in the midst of rampant Russophilia, when political considerations dominated over economic rationality. The billboards were full of posters with the slogan “tovarishi konec” during the electoral campaign. Politicians of the energy-importer Hungary did not care about the potential consequences of these messages on oil price negotiations with the Soviet Union. Practically nobody did care about the annual loss of 1.5 billion USD caused by switching to convertible currency in the Hungarian-Soviet trade – a move urged by Budapest. We relinquished the Russian market pretty easily. The dramatic collapse of the Russian economy, its liberalization during the shock therapy, and its integration into the world market was presented as a success by the Hungarian expertal community.

Exactly during these days a slim, young lady appeared at the Institute of World Economy, Zsuzsa Ludvig. Very soon, she established herself as a respectable researcher by her balanced, detached assessments. She was widely known not only at home, in Hungary but also among Russian academics, even at the famous IMEMO.

I had the privilege with other researchers to work with her on the study book, “Russia in the World Economy”, published in 2001 by Aula publisher. This book collected the most important studies of a research project under her supervision. The project attempted to identify and describe the most important facts, trends and drivers of the Russian economy in the second half of the ‘90ies. Analyzing the most significant interrelations of Russian foreign trade, Zsuzsa brilliantly pointed to the domestic expertal and political misperceptions and impropriety regarding Russia. As she summarized her findings: “The thorough examination of foreign trade as the main element of economic reform or its driver raised many problems... Pushing export when sources are scarce automatically results in the realignment of resources partially at the expense of domestic production, partially by de-emphasizing particular economic sectors... The evolving import structure has also very serious, harmful effects on domestic economy. The robust advance of foreign suppliers on the markets of food and consumer goods is hardly irreversible, squeezing domestic producers. Despite all governmental efforts, this trend threatens their chances for development or even survival.”

She also pointed to the degradation of export structure by the domination of raw materials, the unfavorable ecological consequences, the growing regional differences

etc. Her conclusions were the following: “The situation that proves to be dark even today, will become much more alarming if we consider, that despite of “taking all these problems upon herself” Russia has been losing its share in global trade.” (Page 115-117.)

Despite all our differences in academic approaches, her independent professional attitude, readiness to resist mainstream influences, put Zsuzsa Ludvig on an academic pedestal in my eyes already in the 90’s.

She managed to set her conclusions on a consistent, factual and statistical basis without niggling or entering too much into unnecessary details. She was skillful in pointing to the substance and presenting the most important interrelations in a concise way. These are very important researcher’s virtues. As a research leader she also inspired her colleagues to work in a similar manner.

By the 2000s, Zsuzsi set herself as a respectable, renowned expert in Russian economic studies in Eastern Europe. She became participant and organizer of many international programs. Her field of interest included the integration processes of Post Soviet region and some of its major countries, the global trends in Euro-Asia, the economic relations of European Union and Russia, and the last two decades of Hungarian-Russian relations. She analyzed each research issues in a broad context, taking into consideration the effects of global factors and processes among others. The latter was especially important in the course of analyzing the above mentioned international integration processes.

Zsuzsi was an extremely calm, modest, peaceful and kind colleague. Nonetheless, she argued clearly and honestly with great conviction whether at scientific speeches or at private discussions. We knew that she was living a deep spiritual life in a community and she had a wonderful family. She was often speaking about her children and I talked to her about my grandchildren.

Fate sometimes is very unfair!

*Peter Farkas*

## A YEAR AFTER...

I always envied Zsuzsa for a single, professional reason: she started her career in the late 1980s. She witnessed the final phase of perestroika, the collapse of the Soviet Union, the Gaidar reforms and had the opportunity to closely follow the process of disintegration and the establishment of the new Post-Soviet entities. After three decades of Soviet “zastoi”, Russian time became “thick” with new developments in those years. This was an unrepeatable series of events, providing invaluable experience for experts.

I started my Post Soviet studies in the mid-1990s and missed roughly two-thirds of the Gorbachev-Yeltsin period, the great transformation plot. Thus, in terms of expertise the generation gap between Zsuzsa and me was much larger than normally. Nine years would not have mattered that much in Brezhnev’s ‘70s. Nine years did not matter in our personal relations: my sister was the same age as Zsuzsa, they attended university at the same time, which has helped me in forming a relatively easygoing collegial friendship with Zsuzsa. Nevertheless, due to those nine years of Soviet transformation I will always remain a latecomer in terms of my research experience, and I knew I would never be able to catch up. She was like a veteran of the last war, while I was only an experienced soldier of a long peace period. Even though she never made me conscious of this, the fact was that were speaking about a series of events from which I had been mostly absent.

We were different in almost all aspects. For me, Russia was a choice that involved resistance to the dominant trend of EU and Western European studies that prevailed at the time of my studies. Right from the outset I approached Russia as a personal mission, and this was the only way to become an expert of the region in the mid-1990’s. I had a strong, and irresistible appetite for anything Russian, and a unrelenting eagerness to get more of it without too many scientific considerations. For Zsuzsa, by contrast, Russia as a research topic was more like a long-term engagement involving enduring, though not excessive emotions. Once she told me that she had been assigned to this position and came to love it gradually, over time, like an arranged marriage.

Our working methods were also quite different. It took me a long time to be able to withstand the temptation of excessive conceptualization. I always developed theories – occasionally revelatory but often simply false –, about why and how factors are interrelated, what is important and what is not. In most of these discussions she never flat out told me that I am wrong; all she did was to simply refer to facts, statistics and numbers. She

raised some other considerations that militated against my theories. In her typical reserved way, Zsuzsa had the ability to introduce concise but thorough arguments without actually seeming to debate your arguments. This was often a rather painful experience. So, after a while this compelled me to start collecting more data and to justify my statements at these levels. I remember the first time when she asked me to buy the latest edition of the annually book of Customs Statistics during my stay in Moscow. It was a large green book that contained nothing but figures – rather frightening for beginning experts. It took me another five years to understand its significance and to learn how to use it.

Our attitudes towards various kinds of research activities were also different. Zsuzsa always felt a bit intimidated when she had to hold a lecture. She did not like public appearances, tried to avoid these situations and, when they proved unavoidable, she invested a lot of time and energy to prepare for them. When I invited her to some events I organized, she always asked about all the details. Such consultations became our longest telephone conversations. The funniest moments came just after these presentations, when Zsuzsa finally relaxed and let her worries go. At the same time, all the papers I submitted were read and corrected thoroughly and by the deadline. Every detail, every single mistake or unclear points were identified with a request for correction. When she asked me to submit a paper, I always knew that even if this involved a lot of work for me, the paper would meet all editorial standards. The absence of her balanced, critical attitude and her impressive editorial skills are already making themselves felt in the Russia-related publications of the Hungarian academic community.

Over the years two subjects in our strange triangle have changed: Russia and me. Research on Russia, be it economic or political, requires a much more systematic approach than even in the early 2000s. This is not only a matter of the Putin-regime and its relative stability: increased domestic prejudices and perceptions sometimes matter even more. Zsuzsa was always capable to manage these biases and deliver a consistently high standard. She was able to interpret these debates as part of a comprehensive framework and give them a factual basis. And ultimately I think – or maybe I ought to say I hope – I became a bit like Zsuzsa. My early enthusiasm and excess of emotions about Russia and the Post Soviet region naturally mellowed substantially and their place was taken by strict methodological routine, thoroughness and everyday dedication to the task at hand. As I assumed her position at the Institute, I confronted the myriads of administrative tasks and editorial works that need to be performed in order for the Institute to run smoothly. It is almost impossible to comprehend the significance of Zsuzsa's past work without doing it yourself.

In some Central Asian societies the family gathers on the first anniversary of the funeral. It is a time when the bereaved have come to understand that the person they lost is really absent and know why they miss the deceased. It is a sad but also easy task to enumerate what has disappeared from the small community of Hungarian Russia researchers since Zsuzsa passed away: her absence has made itself felt in the quality of Post Soviet

publications and the declining number of small workshops on Russian economic developments. Nevertheless, for me her absence primarily marks a loss of certainty. On many, particularly economy related, issues Zsuzsa's opinion had always been a kind of guarantee for me. I trusted her opinion since it was always proven correct. She knew her limits and she never engaged in speculation. I often called her to check my assumptions or to try to "steal" some new ideas or perspectives for my work. Now I often ask myself: What would Zsuzsa do in this situation?

*András Deák*

## THE BALANCE I WISH I COULD HAVE LEARNT FROM HER

When I started my career in Russian and Post-Soviet Studies slightly more than a decade ago, Fyodor Tyutchev' old aphorism "*Umom Rossiyu ne ponyat*" seemed more than appropriate. The vastness of Russia's territory, together with the amazing depths of her history and contemporary politics, seemed just impossible to comprehend for a young PhD student such as myself at that time. The more I read about and traveled in the region in my early years as a research assistant, the more hopeless it seemed to go beyond merely scratching the surface and dig deep into this phenomenon. Taking into account this incomprehensibility, I was and still am very grateful to my professors and to my senior colleagues who were kind and ready to share their knowledge with me. Zsuzsa was one of them. However, the story I wish to tell starts earlier.

One could easily name a few members of both the Hungarian and international community of Russia scholars who in one way or another stand out from the crowd, not only in terms of their knowledge but sometimes also in their habits and behavior. As far as the latter is concerned, I do not have the courage to claim that I would be among these exceptions. Actually, I often have the impression that many of us Russia scholars are just a bit, well, different, even from our colleagues who deal with other issues of foreign policy research.

It does not really matter whether it is the subject that has gradually transformed me and many of us, or whether it was just some pre-determined quirks in our personal character that matured over time. What matters is the end result: the cynical, often dark sense of humor, the sometimes extremely relaxed attitude to any hardships, and the habit of disrespecting and questioning everything – because "You can never be sure anyways" – are just a few particularities. I do not know whether this is good or bad; in the end, we might not have to decide at all. However, together with the authors of this book, I have been lucky to know an exception.

I still remember meeting Zsuzsa for the first time on a joint trip to Southern Poland to attend the annual Krynica Zdrój conference in early autumn 2005. My friend and mentor, András Deák, was driving his old Volkswagen, with Zsuzsa sitting in the back seat, chatting with us in her usual, reserved but polite voice, telling us how her children would just love to see the colorful, forest-covered mountains of the Carpathians we were

passing on our way, and contemplating what she should take home as a small surprise for them... Not a single word was said about the crisis of the first “Orange” government in Ukraine, which was supposed to be the main topic of the whole conference. All we spoke about in those few hours were the not the big politics we were just on our way to discuss, but the small but highly important aspects of human life.

For me, Zsuzsa Ludvig meant Balance, where a capital first letter is indeed deserved. Every time I met her, I somehow had the feeling that in Zsuzsa devotion to family life and her commitment to work were in such a balance that I could never hope to achieve. She did not evince even a single trace of those attitudinal features typical of many Russia-researchers. In fact, she had the much-needed understanding of Russia without getting sucked too deep into her. She was really balanced – at least this is how I remember her. And having doubts in oneself and frequently complaining about the lack of time all fit just perfectly into this balance. While in her company, I always felt the deep truth of another Russian proverb “*My rabotaem chtoby zhit’ , a ne zhiviyom chtoby rabotat.*” She knew this very well; in fact much better than I could ever learn it.

I wish I could have known her better. Since regrettably I did not, in reminiscing about her I have to rely on the few common experiences (travels, conferences, and so on) we shared. Unlike many, she was not striving to become any kind of a star, or to gain visibility at any price. Instead, she was the kind of team player who prefers to stay in the background, but without whom no successful collective work is possible in fact. Medals or promotions do not tend to abound for people like Zsuzsa. They are not the ones who are frequently called by the media or are written about in tabloids.

However, positive feedback is something every one of us needs. Some need it more, some less, but none of us can live without it. And she hardly got it to the extent she would have deserved, particularly if one takes into account her achievements. Zsuzsa was severely underrated by many, including both academia and decision-makers. Discussing the underlying reasons would go far beyond the conceptual limits of this book, but one needs to keep in mind that besides the number of articles and citations there are also other, highly important components of an academic career.

Zsuzsa helped many young recent graduates in launching their research careers. Some of her former students went into business, other stayed in the academic field, but Zsuzsa took them all under her wings. While formally she was never a professor at any university, she did more for the next generation of researchers than many old and experienced university professors . She taught without preaching, and made one learn not by commanding but through leading by example.

As in fact we did not collaborate a lot, I gleaned these things more from others than my own personal experience; and particularly not from her, as Zsuzsa would have been the last one to ever boast about her own success. What I know and will most remember about her was that profound balance of hers. My hope is that one day I will be as wise as she was.

Thank you for everything, Zsuzsa!

Sit tibi terra levis!

*András RÁCZ*



## WHAT IS THE BEAUTY OF POST-SOVIET STUDIES?

I do not know whether “beauty” is the most appropriate word, I would prefer something like “intellectual appeal”. What immediately comes to mind in this respect is the well-known argument by Shleifer and Treisman, first advanced back in 2004, which posited that Russia has become a “normal country”. What Shleifer and Treisman meant is that Russia, with all its accomplishments and problems, now looks exactly like a country at her level of development should look like. It does not stretch credulity to apply this notion to Ukraine and other post-Soviet countries as well.

Yet this definition is ambiguous. True enough, in economic terms one can now find a lot of similarities between Russia and, say, the economically more advanced Latin American countries: even a casual visit to both would generally suffice to confirm this. However, there are signs of a new Cold War and the standoff between Russia and the West that results from conflict in Ukraine has once again made Russia’s status special in some sense. Somehow it has managed to attain an upper-middle income level without accepting many of the societal norms that characterize western societies, and is now openly challenging some of them. Intellectually, it is an extremely interesting country to analyse precisely because it is so *different*. The same goes for Ukraine, although this might be not as obvious at first glance.

It would not be very original to attribute these differences to differences in peoples’ mentality – whatever the latter actually means. Still, I believe that understanding mentality can help enormously. My experience shows that doing proper analysis of a country/region requires going well beyond the application of standard economic models (many of which are built on shaky assumptions anyway) and involves ‘soft expertise’, a lot of which is difficult to capture through formal models and is largely built on intuition, but can nevertheless be sometimes very helpful in forecasting future developments. This is where I may have a certain comparative advantage because of my origins: Although I have been living abroad for twenty years, I was born and grew up in the Soviet Union/Russia. Russian is my native language, and somehow I feel myself belonging to the Russian culture or at least certain facets of it (as you may know, Russian culture has a lot of facets, and any generalizations may be highly misleading).

To give an example, intuition was telling me from the very beginning that the western sanctions imposed on Russia in response to the Ukraine crisis would not work and would

even likely prove to be counterproductive – as they have indeed turned out to be. From the ‘western’ point of view, it seemed rather irrational for Russia (in terms of pure ‘cost-benefit’ analysis) to stick to policies that are damaging to her own economy. Yet, that is exactly what Russia did – in my view, not least because for a Russian it would be essentially immoral to sacrifice one’s values for economic benefits.

So these are my very personal reflections on the “beauty of post-Soviet” studies and why I am doing this.

*Vasily Astrov*

## PERSONAL REFLECTIONS ON POST SOVIET STUDIES

Complex, multi-faceted socio-economic phenomena that are influenced by factors of a different nature have always been a challenge of sorts for researchers. They need, in particular, a dynamic approach that can explain how the historical legacy of a social organism transforms into a different structure from which a new entity emerges. Going into the depth of this evolution and its driving forces is to fully comprehend the real beauty of social science! The domain of Post-Soviet Studies gives us such an opportunity, as it provides an intellectual platform for sharing various and often quite different views which reflect the diversity of paths that transformation may follow. The beauty of Post-Soviet Studies springs out of this diversity.

Today, many academic scholars admit that any fundamental research of social processes cannot ignore institutional foundations deeply rooted in national historical experience, cultural patterns and traditions. Together they form what institutional scientists usually refer to as “path dependency”. Taking it properly into account enables us to better understand why this or that attempt at social change was a success or, alternatively, a failure. However, this path dependency is never so pervasive as to predetermine strictly and invariably the exact trajectory of our development. There is always space left for a free construction of our social future. And this interplay of the past and the future in a process of development, in the emergence of something new, is certainly another source of aesthetic satisfaction when a researcher captures the essence.

Post-Soviet Studies deal with cases of extreme complexity because they are devoted to countries and regions that are trying to accomplish fundamental changes; in fact, their path leads to a serious reprogramming or reshaping of their cultural modes of behavior. These processes are full of uncertainty and contradictions that can result in development reversals and, sometimes, even dramatic collapses. Studying all this and trying to predict certain events makes you a real participant in the historical process.

The scope of my research extends far beyond the limits of Post-Soviet Studies. For me, it is not the exclusive field of scientific activity but an essential element of my comprehensive research method based on the study of complexity and dynamic system changes. For me, it is not a sort of relic or antique decoration, but a tool to find answers to difficult questions about the contemporary world. For me, it is not a way to find shelter from today’s uncertainties (people often hide themselves in historical reminiscence

when they do not accept certain features of modernity), but the way of integrating the past and the future. For me, it is a source of important knowledge about mistakes and delusions of the past that, if ignored, are bound to reappear in the future, with even more destructive consequences. That is why I am keen on studying and understanding these matters.

However, in fact, I cannot attribute myself to the sphere of research that is called Post-Soviet Studies. Perhaps it would be even strange for me, a Ukrainian, if I tried to do so. Moreover, I would say that the word “post” makes me cautious: it looks like something that is used as a substitute to describe a new phenomenon whose essence we do not fully understand yet. But in case of the republics of the former Soviet Union, the “post” prefix does not look like something that ignores the future. The new independent states that emerged after the collapse of the Soviet Union are still constrained by Soviet-type institutional legacies. The latter manifest themselves in multiple ways, e.g. in the way people expect paternalist support from the state, adhere to stable hierarchical relations and formal titles, give preference to nepotism, fear competition, and distrust legal practices. All these Soviet-time and pre-Soviet (Tsarist Russia) legacies, enshrined in the sub-consciousness of millions, are huge impediments on the country’s way to Europe. Nevertheless, I would prefer if this designation did not prevail far into the future. Simply because you cannot safely go ahead with your head permanently turned back. To succeed in one’s development, one must hold on to the visual sign of the future that attracts and guides the way. And for Ukraine, at least the more advanced part of the population, this attractor is absolutely clear – it is called Europe. That is why I hope Post-Soviet Studies will ultimately give way to European Studies.

*Volodymyr Sidenko*

## WHY HAS IT BEEN ATTRACTIVE TO PURSUE POST-SOVIET STUDIES?

The short answer to this question is: because I was an eyewitness of the Soviet Union's decline and dissolution in the '80-ies, I had a "parallel life" with late "zastoi" thus it has become part of my life.

The longer one is as follows. I graduated from the Moscow State Institute of International Relations in 1984, just a year before *perestroika* began. Our was the last year that had to take exams – among other soon-to-be abandoned subjects – on "hardcore" communist party congresses of the late Brezhnev-era. Students in subsequent years began to deal with the reform of the communist system under Gorbachev – this was the beginning of a new era.

When I got back to Hungary, I entered the Hungarian Institute of International Relations. Perestroika was still in its early phase and as part of my research interest I followed how the process of reforms was unfolding.

Coming from and working in Central Europe I decided to write my PhD dissertation on "Soviet Policy Towards Eastern Europe in the Gorbachev Era, 1985-1991". Perestroika (changes in domestic politics) and Soviet foreign policy were rather intensely studied, but the Eastern-Central European aspect of this process was poorly researched, and thus it is my hope that my dissertation can contribute to a better interpretation of this dimension of Soviet reforms.

Since the dismantlement of the Soviet Union in Belovezhskaya Pushsha (Belarus) in late 1991, Soviet studies have become post-Soviet studies. This shift has not made my field less interesting; on the contrary, it has significantly widened in scope with the appearance of 15 post-Soviet states and new regions.

Going back to Moscow after graduation was always highly interesting. When I returned there in 1990, everything seemed unchanged. Within the span of only a few years, however, the changes became striking: renovated orthodox churches and new skyscrapers dotted the city. During visits to my university, the abundance of luxury vehicles belonging to students of so called "new Russians" (Russians, who grew rich very fastly after the Fall of Communism – *editor's comment*) was a very unpleasant and telling experience reflecting the changing times.

Studying the post-Soviet space also had a very nice “side effect”: as the region has global importance, the topic was interesting everywhere-R This gave me the chance to win fellowships worldwide, and correspondingly I have traveled as far as the US and Japan to analyze the Soviet Union and, subsequently, Russia.

*László Póti*

THE CONFLICT  
IN EASTERN UKRAINE AND ITS  
IMPLICATIONS

ANDRÁS RÁCZ<sup>1</sup>

## RUSSIA'S HYBRID WAR IN UKRAINE: WHERE ELSE COULD MOSCOW DO IT?<sup>2</sup>

The new type of warfare – often referred to as hybrid war – that Russia has conducted in Ukraine has attracted widespread political, public and academic attention, particularly following the annexation of the Crimean peninsula. However, when reading media reports one may have the impression that the real potential of Russia's hybrid warfare is often overestimated, and, as a result, it comes to be perceived as a universal and invincible form of warfare that may constitute a threat to essentially any country.

Hence, the present paper intends to identify the strategic and operational requirements of hybrid warfare, based on studying both the relevant developments in contemporary military theory and also the field experiences gained in Ukraine. The aim of this research is to identify the countries against which Russia may deploy the full spectrum of this new type of warfare.

The paper is composed of four main parts. First, a short overview is provided about the literature on Russia's hybrid war, including its background in Russian military theory. The second chapter describes the main operational phases of hybrid warfare and the ways in which it works, while the third part deals with the prerequisites of this type of warfare, as far as those can be identified based on the events in Ukraine. The paper ends with a fourth, concluding chapter.

The paper focuses on the period from the beginning of the Crimea crisis until August 2014. The endpoint of our analysis is tied to the massive intervention of Russian regular forces in August last year, which was aimed at preventing the defeat of the separatists that fought against the Ukrainian counterattack, the so-called Anti-Terror Operation (ATO). As a result of the Russian intervention, the conflict was transformed from a hybrid war into a conventional – albeit limited – war. The author takes it for granted that the basic timeline of the events in Ukraine are known, wherefore extensive chronological footnoting is omitted.

Besides, when studying the Russian hybrid warfare in Ukraine, one also needs to be aware of the methodological implications of the shortage of reliable sources of

<sup>1</sup> The views presented here are of the author's own, and they do not represent the position of the Finnish Institute of International Affairs.

<sup>2</sup> The first version of this article was presented at the Annual Conference of the British Association for Slavonic and East European Studies (BASEES) in Cambridge on April 3, 2015.



information. First, this new form of warfare constituted an unprecedented way of achieving political and military victory, thus there is practically no prior academic literature available. Thus one had to rely on an inductive methodology and try to draw general conclusions from the concrete events on the ground. However, a second problem is that widespread disinformation and propaganda efforts from both sides make it hard for the analysts who rely only on open sources to properly study the tactical situation. Consequently, researchers mostly have to rely on the relevant and publicly available articles of Russian military theorists, as well as the often unreliable reports coming from the frontlines. Proper academic analysis of hybrid warfare is still in a nascent phase. Though there are a few thoroughly researched articles about certain specific aspects of hybrid warfare, comprehensive works on this topic have yet to be written.

It needs to be stated in advance that the paper is built on the assumption that Russia has been an active supporter and participant of the crisis in Ukraine, both in case of Crimea and in Eastern Ukraine.<sup>3</sup> In other words, the position the present paper takes is opposed to the official stance of the Russian Federation, which denies any direct involvement in the conflict.

### **1. The Background of Hybrid Warfare in Russian Military Thinking**

Russian military theorists have been continuously following the newest developments in modern warfare. In this respect, the breakup of the Soviet Union did not constitute a significant turning point: Post-Soviet Russian military science basically maintained the high quality of its Soviet predecessor.

In his book *If War Comes Tomorrow*,<sup>4</sup> first published in 1995, Russian General Makhmut Gareev already argued that technological progress has fundamentally changed warfare,

<sup>3</sup> Among the evidence that supports this claim, one should point especially to a declaration by Russian President Vladimir Putin in April 2014, in which he admitted that Russian special forces played a key role in the annexation of Crimea. Second, the massive involvement of regular Russian military forces in Eastern Ukraine was also proved by several studies based on analyses of weapons systems and equipments used by the separatists. The presence of several weapons that are in service only in the Russian armed forces and have never been exported has been documented in Eastern Ukraine, including the Tornado-S multiple-launch rocket system, the Pantsyr air defense system, T72b3 tanks, etc. There was no way for these to make their way into Eastern Ukraine by any other route and means than from Russia and with Russian involvement. Thirdly, a growing number of relevant personal testimonies are becoming public, both from former Russian militants who served in the ranks of the separatists and from regular Russian soldiers. Concerning the latter, one may read, for example, the March 2, 2015 edition of *Novaya Gazeta*, which features an interview with a Russian tank crewman who served and was severely injured in Eastern Ukraine. Fourth, Ukrainian armed forces have captured regular Russian paratroopers in August 2014, together with their tanks and APCs, deep in Ukrainian territory. The official Russian explanations about how these soldiers had “accidentally” crossed the border was hardly credible, because they were captured over 15 kilometers from the border. Finally, NATO and US sources keep providing detailed photographic and satellite evidence about Russian troop movements in and into Eastern Ukraine.

<sup>4</sup> Gareev, M., *If War Comes Tomorrow? The Contours of Future Armed Conflict*. Translated by Yakov Vladimirovich Fomenko. Routledge, Abingdon, 1998.

in terms of both, the destructive effects of conventional weapons and the emergence of completely new forms of weapons. He predicted that due to the increased range of missile and artillery systems, in a future war the entire depth of enemy territory could be easily attacked. Gareev frequently refers to the works of various Western scholars in his book, demonstrating that Russian military science has been fully aware, and able to follow, react to and further develop the ideas of their colleagues in the West.

Gareev pointed out that technological development made the methods and means of information warfare much more sophisticated than they were before. New computers and communication systems allow for the fast collection of information and rapid-reaction command and control. He predicted the widespread use of electronic warfare aimed at disrupting the functionality of enemy communications, radar systems and command and control mechanisms.<sup>5</sup>

The White Paper published in 2003 constituted an important turning point in Russian military operational art. The White Paper cast Russia as a country threatened from all directions, implying that she needs to be ready to take the strategic initiative. The document reflected on many changes in modern warfare already mentioned by Gareev and others, for example the replacement of close contact fighting by in-depth precision strikes and long-range fire combat, the increasing importance of information warfare, the emergence of global communication networks in command and control, and the need to employ combined strike capabilities.<sup>6</sup>

These ideas about future armed conflicts were substantially improved by General Valery Gerasimov, Chief of the General Staff of the Russian Federation, in an 2013 article written for the journal *Voенно-promishlenniy kurier*.<sup>7</sup> Referring to the experiences of the Arab Spring, Gerasimov described a new form of warfare called “new generation warfare,” which, instead of waging open war, focuses on the combined use of diplomatic, economic, political and other non-military methods with direct military force. According to Gerasimov, the very rules of warfare have changed. The Russian general argued that the importance of non-military means in reaching political and strategic goals has radically increased; moreover, they are often more efficient than the exclusive use of armed violence.

Gerasimov prefers the covert and non-open use of armed forces, such as paramilitary and civilian insurgent units. He also emphasizes the necessity of relying on asymmetric and indirect methods. He suggests that in addition to its physical dimension, war should also extend to the information space, where it is possible to perform a real-time coordination of the methods and instruments deployed. He puts a great emphasis on

<sup>5</sup> Gareev, op. cit, pp. 51-52.

<sup>6</sup> Ibid, p. 33.

<sup>7</sup> Gerasimov, V., ‘Tsennost’ nauki v predvideniye’, *Voyenno-promishlenniy kurier*, Feb. 27, 2013, <<http://www.vpk-news.ru/articles/14632>>, accessed Jan. 19, 2015.

targeted strikes conducted far behind enemy lines, and on the destruction of critical enemy infrastructure, including both its military and civilian elements, preferably in a short time. Gerasimov advocates the massive use of special forces and of robotized weapons, such as drones. He argues that regular forces should only be deployed in the late phases of the conflict, often disguised as peacekeepers or crisis-management forces.

Sergei Chekinov and Sergei Bogdanov<sup>8</sup> further expounded on Gerasimov's proposals and provided a much more detailed description of the "new generation war." The authors declared that the second Gulf War was the first "new generation conflict" in human history, and they use it as an example to demonstrate their theses about the characteristics of this type of warfare, along with a general concept of network-centric warfare.

They agree with Gerasimov in stressing the key importance of asymmetric actions aimed at neutralizing the enemy's military superiority by the combined use of political, economic, technological, ecological and information campaigns. Citing the lessons of the Gulf War again, the authors point to the need for integrating all these tools into a single shared system of command and control in order to multiply their efficiency.

Similarly to Gerasimov, Chekinov and Bogdanov also write very explicitly about the need to massively use non-military methods prior and during the armed confrontation. They specifically list media, religious organizations, cultural institutions, NGOs, civil movements financed from abroad, and scholars engaged in research conducted with foreign grants as possible components of a coordinated attack against the targeted country. According to the authors, new generation wars will be dominated by psychological and information warfare aimed at depressing the morale of enemy troops and populations, thus breaking their will to resist.<sup>9</sup>

## 2. Hybrid War in Practice

One of the first comprehensive studies on the newly emerging Russian warfare was written by Latvian analyst Jānis Bērziņš, shortly after the Crimean crisis.<sup>10</sup> In his April 2014 paper, Bērziņš studied in detail both the political and narrative background of Russian operations in Crimea, and also some of their tactical details.

He interpreted these operations in the context of the abovementioned article by Chekinov and Bogdanov, as well as Gerasimov's study, and demonstrated how the strategic

<sup>8</sup> Chekinov, S. – Bogdanov, S., 'The Nature and Content of a New-Generation War', *Military Thought*, October-December 2013, pp. 12-23, [http://www.eastviewpress.com/Files/MT\\_FROM%20THE%20CURRENT%20ISSUE\\_No.4\\_2013.pdf](http://www.eastviewpress.com/Files/MT_FROM%20THE%20CURRENT%20ISSUE_No.4_2013.pdf), accessed 5 March 2015.

<sup>9</sup> Ibid, p. 16.

<sup>10</sup> J. Bērziņš, *Russia's New Generation Warfare in Ukraine: Implications for Latvian Defense Policy*, National Defense Academy of Latvia. Centre for Security and Strategic Research, Riga, 2014, <http://www.naa.mil.lv/~media/NAA/AZPC/Publikacijas/PP%2002-2014.ashx>, accessed March 5, 2015.

concepts used by these Russian theoreticians were implemented in practice. The article emphasized the importance of strategic communications that supported the operation. Coherent and well-coordinated Russian strategic communications were able to slow Western reactions, and were also very successful in weakening Ukraine's resistance capabilities. All in all, without a single targeted shot fired, approximately 10,000-12,000 Russian assault troops were able to ensure that all the 190 Ukrainian military bases and facilities in Crimea surrendered, as did approximately 16,000 members of the Ukrainian armed forces.

Bērziņš also pointed out that both before and during the operation in Crimea, Russia continuously maintained an image of legality in order to justify its actions, and also to stop the outside world from reacting properly to said actions. The Kremlin also claimed that the removal of President Yanukovich constituted a breach of Article 112 of the Ukrainian constitution, which regulates the process of impeaching the president. Moreover, Putin was authorized by the State Duma to use Russian troops in Ukraine if necessary. The whole process of the referendum on independence also meshes with this overall strategy, i.e. it was intended to strengthen the faux legality of the entire operation, by claiming that this was a case of self-determination similar to Kosovo.<sup>11</sup>

Furthermore, Russia kept claiming that its forces were not directly involved in the conflict, and that the armed militants belonged to local self-defense forces. Similar claims were later repeated in the context of the conflict in Eastern Ukraine. Though many Western experts soon pointed out that these claims were false,<sup>12</sup> they were still able to sow confusion among Western policy-makers and in the general public.

### **Operational Phases of the Hybrid War**

By inductively analyzing the operations Russia has conducted in Crimea and in Eastern Ukraine, hybrid war can be described as a type of warfare composed of three main phases, which are in turn each composed of three sections. Naturally, this classification is an abstraction derived from concrete events that took place on the ground, and by necessity it is a theoretical construct that is not in any way directly related to actual information about Russian operational planning, as the latter most probably constitute well-guarded state secrets in Russia. However, even as a construct it may still turn out to be useful for those who are trying to better understand the way hybrid warfare works – and also for those who need to come up with necessary countermeasures.<sup>13</sup>

<sup>11</sup> Ibid, pp. 3-4.

<sup>12</sup> For example, see: International Centre for Defence Studies, *Russia's Actions Against Ukraine*, June 10, 2014, Tallinn, <http://www.icds.ee/fileadmin/media/icds.ee/failid/ICDS%20-%20Russia%92s%20Actions%20against%20Ukraine.pdf>, accessed March 17, 2015.

<sup>13</sup> The author would like express his gratitude to Julian Cooper for reminding him about the difference between thoroughly analyzing the subject and producing a how-to manual for hybrid war, to avoid repeating what Edward Luttwak did in his famous work *Coup d'Etat: A Practical Handbook*, published in 1968.

The first, preparatory, phase of the conflict mainly contains measures that mostly hew close to the traditional diplomatic and soft coercion activities undertaken by Russia. These are described in detail by James Sherr, among others.<sup>14</sup> In other words, several types of actions performed by Russian diplomacy may also serve as a basis for future acts involving hybrid warfare, in addition to fulfilling their traditional purposes. Put differently, the initial phase of hybrid war is built on the traditional arsenal of Russian foreign policy, in line with the increasing importance of non-military measures in Russia's concept of new generation warfare.

Hence, it is practically impossible to determine whether traditional Russian measures aimed at expanding the country's influence may in a given context also serve to lay the groundwork for a hybrid attack, before the offensive actually starts. Furthermore, many of the actions listed below are not explicitly or necessarily illegal, which makes it hard for the target country to defend itself against them.

The preparatory phase of hybrid war – or, in other words, those traditional measures of Russian foreign policy that may serve as a basis of a hybrid war – can be divided into three sections. These are the following:

<b>Section 1</b>	<p><b>Strategic preparation</b></p> <ul style="list-style-type: none"> <li>• Exploring points of vulnerability in the public administration, economy and armed forces of the target country</li> <li>• Establishing networks of loyal NGOs and media channels on the territory of the target country</li> <li>• Establishing diplomatic and media positions in order to influence the international audience</li> </ul>
<b>Section 2</b>	<p><b>Political preparation</b></p> <ul style="list-style-type: none"> <li>• Strengthening dissatisfaction with the central authorities in the target country by using political, diplomatic, special operation and media instruments</li> <li>• Strengthening local separatist movements and fueling ethnic, religious, social, etc. tensions</li> <li>• Actively using information measures against the targeted government and country</li> <li>• Bribing and “turning” politicians, administrative officials and armed forces officers</li> <li>• Establishing relations with local oligarchs and businessmen; using profitable contracts to make them dependent on the attacking country</li> <li>• Establishing relations with local organized crime groups</li> </ul>
<b>Section 3</b>	<p><b>Operational preparation</b></p> <ul style="list-style-type: none"> <li>• Launch coordinated actions of political pressure and disinformation</li> <li>• Mobilization of “turned” officials, officers and local criminal groups</li> <li>• Mobilization of Russian armed forces under the pretext of military exercises</li> </ul>

<sup>14</sup> J. Sherr, *Hard Diplomacy and Soft Coercion. Russia's Influence Abroad*. Chatham House, 2013, London.

No overt violence is used during the preparatory phase, and in a theoretically ideal case the authorities of the target country do not actually see what is happening. When the attacking country actually launches a full-scale hybrid offensive, all the weaknesses previously explored during the preparatory phase are suddenly laid bare, in line with the principles laid down by Chekinov and Bogdanov. This is the moment when hybrid war clearly becomes different from the traditional actions of Russian foreign and security policy described above.

The attack phase also has three sections:

<b>Section 4</b>	<p><b>Exploding tensions</b></p> <ul style="list-style-type: none"> <li>• Organizing massive anti-government protests and riots in the attacked country</li> <li>• Special forces that infiltrate the target country disguised as local civilians carry out the first sabotage attacks, capture the first administrative buildings in the targeted regions (with the active or passive support of corrupted local officials and police), in cooperation with local criminal groups</li> <li>• Provocations and sabotage attacks take place everywhere in the target country, in order to distract the attention and resources of the central power</li> <li>• The media of the attacking country launches a massive disinformation campaign.</li> <li>• In the meanwhile, the capabilities of the target country to counter-attack are blocked by Russian regular forces, which are amassed along the border to pose an imminent threat of an overwhelming conventional attack.</li> </ul>
<b>Section 5</b>	<p><b>Forcing the central government out of the targeted region</b></p> <ul style="list-style-type: none"> <li>• Rendering the regional operations of the central government impossible by capturing administrative buildings and telecommunication infrastructure in the targeted region</li> <li>• Blocking the central government's media access, establishing communication and information monopoly</li> <li>• Disabling the central government's armed forces in the region through methods that do not use actual violence: blockading their barracks, bribing their commanders, breaking their morale, etc. Disabling border guards is particularly important.</li> <li>• Meanwhile the diplomacy, media, economic actors and armed forces of the attacking country put strong pressure on the target country. The media of the attackers tries to mislead and disorient the international audience and to discredit the target country.</li> </ul>

<b>Section 6</b>	<p><b>Establishing alternative sources of political power</b></p> <ul style="list-style-type: none"> <li>• Establishing an alternative system of government based on captured administrative buildings, citing real or fabricated traditions of separatism.</li> <li>• Replacing the administrative organs of the central government with newly established political bodies, thus creating quasi-legitimacy</li> <li>• The media of the attacking country bolsters the legitimacy of the new political bodies.</li> <li>• Alienating the local population from the central government by using the information monopoly</li> <li>• The counterattack capabilities of the central government are continuously blocked by the threat of a conventional military attack.</li> </ul>
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As was demonstrated both in Crimea and Eastern Ukraine, towards the end of the attack phase the resistance potential of the target country is broken, its governance, command, control and communications capabilities are severely damaged, and it loses control over one or more parts of its territory. However, in the cases in question such success would not have been possible without capitalizing on the inherent and manifold weaknesses of Ukraine, which were explored in the operation's preparatory phase. In other words, if sufficient weaknesses cannot be identified in the target country, then a full-scale hybrid offensive is never launched. Unfortunately, this was not the case in Ukraine.

However, in order to stabilize the results achieved, the attacking country needs to take additional steps, as was demonstrated in Crimea. One may refer to this third phase as strategic stabilization, and like the other phases, it can also be divided into three sections.

<b>Section 7</b>	<p><b>Political stabilization of the results</b></p> <ul style="list-style-type: none"> <li>• Organizing a 'referendum' and the subsequent decision about secession/independence from the target country, all with the strong diplomatic and media support of the attacking country</li> <li>• The new 'state' asks for the help of the attacking country</li> </ul>
<b>Section 8</b>	<p><b>Separation of the captured territory from the target country</b></p> <ul style="list-style-type: none"> <li>• 8/a: attacking country annexes the captured territory (Crimea), or</li> <li>• 8/b: establishes a military presence there (which may be open or covert), and starts fighting the central government in the name of the newly established 'state', thereby weakening the former in the political, economic and military sense (Eastern Ukraine). A sub-variant is an open invasion under the pretext of 'peacekeeping' or 'crisis management.'</li> </ul>
<b>Section 9</b>	<p><b>Lasting limitation of the strategic freedom of movement of the attacked country:</b></p> <ul style="list-style-type: none"> <li>• Loss of territory (economy, population, infrastructure, etc.) results in severe economic hardships, domestic political destabilization and possibly grave humanitarian situations</li> <li>• Lacking full control over its territory, the attacked country is unable join any political or military alliance that requires territorial integrity</li> </ul>

One needs to note that the full spectrum of hybrid warfare, as it was detailed above by way of inductive classification, was only realized in Crimea. In Eastern Ukraine, however, separatism failed to attain a momentum that was strong enough to ultimately result in secession. The different dynamic owed mostly to the low levels of local support and to the Ukrainian government's counterattack launched in May 2014. Following a summer of intensive fighting and a gradual retreat of separatist militants, the massive intervention of Russian regular forces in August 2014 finally transformed the conflict into a conventional, though limited war.

### **3. Prerequisites of engaging in a full-scale hybrid war**

In order to identify the prerequisites of engaging in hybrid wars, one needs to remember that the earlier, non-violent phases of this form of warfare do not constitute illegal or violent actions. In fact, in many cases they do not differ substantially from the conventional tools of Russian diplomacy, such as gathering information, establishing contacts with decision-makers, setting up media outlets, supporting cultural projects and pro-Moscow NGOs, etc. Consequently, this article will analyze what is needed to launch a full-scale hybrid war, i.e. one which also involves overt and covert physical attacks, as well as territorial conquests.

#### **Military superiority**

Based on the phases described in the previous chapter, one may conclude that the most important prerequisite for launching a full-scale hybrid war is that Russia needs to be militarily stronger than the target country. In the European context means this means that the target country may not be a member of either NATO or any military alliance with a significant military potential as compared to Russia's own.

This is essential because Kiev was unable to use force against either the "polite green men"<sup>15</sup> or against the violent protesters due to the danger of an overwhelming conventional attack by Russia. One needs to remember that both during the events in Crimea and the beginning of the crisis in Eastern Ukraine, massive Russian forces were marshalled along the border with Ukraine. Though the Kremlin officially justified their presence by claiming that they were only participating in snap exercises, in reality they posed an imminent military threat to Ukraine. Taking into account the fact that Russia maintains the right of defending Russian-speakers abroad, even with the use of force if necessary, the Ukrainian leadership could hardly risk to respond with force to the invaders, because doing so might easily have provoked a full-fledged Russian attack.<sup>16</sup> In other words, the danger of a massive Russian conventional military attack on Ukraine functioned as a deterrent, thereby seriously limiting Kiev's scope of action. However,

<sup>15</sup> Russian special forces soldiers were nicknamed "polite green men" by the Russian press during and after the operation in Crimea.

<sup>16</sup> Pointed out, for example, by James Appathurai at the Riga Conference in September 2014.



as stated above, this deterrent works only if the target country is militarily weaker than Russia and has no allies who are either capable of guaranteeing its defense or possess a military force comparable to Russia's. Otherwise, if the deterrence element can be neutralized, for example with the help of NATO collective defense, then the "polite green men" and their local armed allies can be arrested – and, if police means are not sufficient, destroyed by military force – the very first moment when they show up.

#### **Weak Central Power and Armed Forces in the Target Country**

As described above, both the preparation and the attack phase of the hybrid war are largely built on exploiting the inherent weaknesses of the target country. Weak central leadership, badly functioning state administration and underpaid, corruption-infested police and armed forces all increase the target state's vulnerability, particularly against infiltration and bribery. By contrast, a well-functioning and strong state administration, jointly with correspondingly capable police and secret services, are able to quickly uncover and suppress diversionary activities controlled from abroad.

However, for a variety of reasons the Ukrainian state proved unable to do so during the Crimean crisis. First, the entire state has been infested by extremely high levels of corruption, which reach even the highest echelons of the public administration. According to a 2013 survey by Transparency International, under President Yanukovich Ukraine was the third most corrupt state in Europe, following Belarus and Russia.<sup>17</sup> These structural weaknesses of the public administration obviously did not disappear as a result of the political transition that took place in February 2014. Besides, oligarchs have a strong influence not only on the political elite, but also on the police, border guards and secret service structures, particularly in Eastern Ukraine.<sup>18</sup>

The low and/or questionable legitimacy of the government is an additional factor that may weaken the resistance potential of the target country. This was particularly the case during the Crimean crisis, when the new leadership in Kiev faced serious problems of legitimacy and everyday functioning. Though the election of Petro Poroshenko as president on May 25, 2014, helped address legitimacy problems, functional troubles still persist. In Crimea, Russia and its local proxies were highly successful in exploiting the weak legitimacy of the new government in Kiev: They did so by using propaganda and spreading false news, which significantly lowered the morale of Ukrainian forces stationed in the peninsula. Isolated from any alternative sources of information, low-ranking local Ukrainian commanders often decided to surrender under the pressure of Russian information warfare.

<sup>17</sup> Transparency International, *Corruption Perceptions Index 2013*, < <http://cpi.transparency.org/cpi2013/results/> >, accessed March 19, 2015.

<sup>18</sup> Matuszak, S., 'The Oligarchic Democracy. The Influence of Business Groups on Ukrainian Politics', *OSW Studies* No. 42, Centre for Eastern Studies, 2012, Warsaw, < [www.osw.waw.pl/sites/default/files/prace\\_42\\_en.pdf](http://www.osw.waw.pl/sites/default/files/prace_42_en.pdf) >, accessed March 5, 2015.

Another component of the weakness of the Ukrainian state was that there were large numbers of officials in the armed forces and the police and security services who were loyal to Moscow rather than Kiev. In fact, even the president himself was no exception. The Yanukovich-regime deliberately weakened the SBU's (*Sluzhba Bezpeki Ukraini*) counter-intelligence capabilities aimed at Russia, and massively compromised the organization by sharing information about it with Moscow.<sup>19</sup> Information leakage from the SBU was so massive that when special forces units were sent from the capital to Crimea to arrest Yanukovich, who had fled there, the former president was informed of the action already before the commandos even departed Kiev.<sup>20</sup> In order to enable the SBU to properly fulfill its functions, the entire organization had to be restructured and rebuilt first.

There were also many professional soldiers in the conventional armed forces who ultimately chose Russia over Ukraine. In a particularly striking instance, Rear-Admiral Denis Berezovsky, the supreme commander (!) of the Ukrainian fleet, called on the entire fleet to switch sides and swear allegiance to Moscow. Following the annexation of the peninsula, over 5,000 Ukrainian soldiers and navy personnel decided to continue serving in the Russian armed forces.

#### **Lasting, Regionally Concentrated Dissatisfaction with the Central Government**

In order to successfully implement the fourth and the subsequent phases of hybrid warfare, there has to be a lasting, regionally concentrated dissatisfaction with the central government, preferably with an ethnic or separatism-related element involved. This dissatisfaction may serve both as a ground and a pretext for organizing political, and then later armed opposition against the central government, as well as for demands of autonomy and independence.

Such dissatisfaction, strengthened by ethnic and language-related elements, has been present both in Crimea and Eastern Ukraine. Though a detailed description of its causes would far exceed the framework of the present paper, one needs to note that this dissatisfaction was closely connected to the overall corruption and disfunctionality of previous Ukrainian governments during the last two decades. Hence, it was not hard for activists organizing pro-Russian civil society networks, and later also for Russian agents and special forces coordinating demonstrations, riots and the takeover of administrative buildings, to find like-minded people among the locals.

#### **Massive presence of Russian-speaking minority**

For a variety of reasons, another important prerequisite is the massive presence of a Russian or Russian-speaking minority in the target country. It is probably easier to find

<sup>19</sup> Sherr, J., Ukraine's Fightback has surprised the Kremlin, *The World Today*, August-September 2014, pp. 34-36.

<sup>20</sup> Interview with a high-ranking official of Ukraine's National Security and Defense Council, May 2014, Kiev.

individuals who are dissatisfied with the central government among the members of ethnic minorities; these can then be recruited to engage themselves on behalf of the attacking country. They may serve not only as sources of tactical and operational intelligence, but may also provide shelter and guidance for infiltrating special forces, and participate in organized anti-government protest and riots.

The presence of Russian-speakers enables the special forces of the attacking country to disguise themselves as locals, and act as civil society activists, members of the local opposition, etc. Furthermore, it also makes it possible for the attacking country to formally deny its involvement. Moreover, disguising infiltrating special forces as locals also limits the potential of the target country to use force against those who engage in illegal acts. Responding violently, that is shooting “civilians,” may undermine the government’s legitimacy, could generate an adverse reaction in the international media, particularly if the media of the attacking country pounces on the issue, and, finally, it may also cause morale problems inside the armed forces.

#### **Strong media presence both in the target country and abroad**

An additional prerequisite is that the attacking country must possess a strong media presence in the target country. An established and properly functioning media enables the attackers to generate and strengthen distrust vis-à-vis the central government, to isolate the attacked region from any information coming from the capital, as well as to mislead and misinform both the majority society of the target country and the international community.

In Ukraine, the Russian media has traditionally held strong positions, owing in part to the high ratio of Russian speakers in the population and also to the significant share of Russian-owned companies in the Ukrainian media market. In addition to the aforementioned, Russian-speakers in Ukraine frequently watch and read, and mostly even prefer, Russian television channels and local versions of Russian newspapers, respectively. Taken together, all these provide Moscow with strong media positions in Ukraine.<sup>21</sup>

Furthermore, as pointed out by Keir Giles,<sup>22</sup> Russia has invested considerable time and resources in setting up strong media positions in the Western world as well. Well-coordinated information offensives conducted by Russian-operated TV and news channels operating in Western languages, together with a whole army of internet trolls, enabled Russia to sow confusion and mislead the Western public with a set of conflicting narratives and “*obscure the truth with a thicket of falsehoods.*”<sup>23</sup> Western media proved particularly vulnerable to Russian information warfare operations because in compliance with the principle of providing balanced information, the Russian narrative also had to

<sup>21</sup> Szostek, J., ‘Russia and the News Media in Ukraine. A Case of “Soft Power”’, *East European Politics and Societies and Cultures*. Vol. 28. No. 3. August 2014. pp. 463-486.

<sup>22</sup> Giles, K., ‘Russia’s Hybrid Warfare: A Success in Propaganda,’ *Working Paper*, 2015/1. Bundesakademie für Sicherheitspolitik.

<sup>23</sup> *ibid.*

be provided with sufficient space in the coverage of the relevant events, even if it advanced blatant and obvious, often contradictory lies.

The importance of strong media positions and information warfare in general leads to the conclusion that without the existence of modern media, no hybrid war can be waged. Consequently, this type of warfare is unsuitable for an environment where the level of technological development is low. Besides, one may be tempted to also conclude that the successful implementation of hybrid warfare is to a certain extent also culture-dependent. The attacker needs to know and master not only the language and culture of the target country, but also its main political and historical narratives, the dominant discourses, and how they can be publicly presented and debated. This aspect of the research needs further elaboration, however.

### **Logistical requirements**

In addition to the factors mentioned above, the implementation of the full spectrum of hybrid warfare also has certain logistical requirements. Though this element cannot be reconstructed based on the publicly available Russian sources, the events in the Ukraine still allow us to draw certain conclusions.

The full spectrum of hybrid war requires that there is either a substantial Russian military presence in the targeted region, as was the case in Crimea, or that the given region shares a common border with Russia, while the borders are weakly guarded or not at all, as in Eastern Ukraine. Direct proximity to Russia or to Russian military bases is also needed to provide the attackers – including special forces and their local allies – with shelter, food, drink, weapons, ammunition, fuel and equipment. Sending additional troops or evacuating the wounded also makes it necessary to maintain constant and uninterrupted contact with the hinterland.

In other words, the full spectrum of hybrid war cannot operate in isolation. While individual agents may operate independently, as may small special forces for a little while, the massive implementation of the second and third phases of hybrid war require constant logistical support.

## **4. Conclusions**

The new form of warfare Russia has employed in Ukraine, often referred to as hybrid warfare, is not a newly crafted instrument but the result of an organic evolution in Russian military thinking. It emphasizes the importance of non-military methods in defeating the enemy country. Rather than relying on direct military force, hybrid warfare uses political, economic, diplomatic, social and information measures together with special forces operations to break the target country's ability to resist.

Hybrid warfare is not a universally applicable military tool though. In fact, there are a number of strategic and operational requirements that need to be met in order to successfully employ hybrid warfare. However, there is still a methodological gap in the research concerning the exact nature and scope of these requirements, since the full spectrum of hybrid warfare was deployed only in two cases thus far, namely Crimea and Eastern Ukraine, which offers a rather limited dataset for research and analysis. Hence, one cannot assert with any level of certainty that all these prerequisites are in fact always necessary for waging hybrid wars. Instead, one can only claim that in both cases of hybrid warfare experienced so far they were of essential importance.

The most important prerequisite is that Russia needs to be militarily stronger than the target country. The danger of a massive and overwhelming conventional offensive by Russia is the factor that prevents the target country from using force against the attackers conducting hybrid warfare. This leads to the conclusion that hybrid warfare is not a substitute for conventional military force but a new way of using it, i.e. mainly as a factor of deterrence with no or very limited kinetic violence involved.

The weakness of the central government and of the system of public administration in general, is another key element that allows the hybrid attacker to weaken the resistance capabilities of the target country by corrupting, blackmailing and turning government officials, as well as army and police personnel. Ongoing and regionally centered dissatisfaction is an additional key element that an adversary employing hybrid warfare may try to exploit. Russian or Russian-speaking minorities need to be present in the target country in order to make it possible for the infiltrating special forces to disguise themselves as locals, and also to serve as a basis for gathering intelligence and to conduct recruitment. Russian media need to have a strong influence in the target country, thereby enabling Moscow to use the full spectrum of its information warfare potential. In terms of logistics, there either has to be an established Russian military presence in the target country already before the operation, or the target country has to have a long and weakly controlled border with Russia, which will allow for the provision of logistical support.

Taking these preconditions into account, one may conclude that the number of countries where Russia would be able to deploy the full spectrum of hybrid war – i.e. not only preparations and non-military measures aimed at exercising pressure but an actual attack – is in fact very limited. At present, all preconditions of a hybrid war are met in Ukraine (still) and in Georgia. In Belarus and Kazakhstan almost all preconditions are met except the weakness of the central government, as these countries have strong and centralized presidential regimes. Moldova and Armenia are far less vulnerable to such an attack since they do not share a direct border with Russia. Correspondingly, the small Russian bases isolated from Russia itself are clearly not suitable for anything involving a military component.

Meanwhile, if the preconditions listed above are correct, then this would also imply that the Baltic States are much less vulnerable to hybrid warfare than they are often perceived to be, despite the massive presence of Russian-speaking minorities in Estonia and Latvia. NATO membership, and in particular the fact that NATO forces are stationed in their territories, provides the Baltic States with a much more credible military defense than that enjoyed by any of the other former Soviet Republics. Hence, the key element of hybrid warfare, i.e. deterrence through a potential massive conventional attack, could be neutralized in this context. Moreover, as compared to the post-Soviet countries listed above, good governance is much more prevalent in the Baltics, corruption levels are lower, and the system of public administration is also more solid and coherent.

One may therefore conclude that hybrid warfare is indeed far from an invincible universal threat, or some kind of “Wunderwaffe.” Instead, its full deployment, i.e. the way it was conducted in Ukraine, is contingent on a number of strategic and operational conditions, which are only met in a few countries of the post-Soviet region.

However, the fact that a full-scale hybrid war poses an acute threat only to a small number of countries does not imply that in conflicts with other countries Russia cannot employ its hybrid toolbox, i.e. the perfectly coordinated use of political, diplomatic, economic, information and other measures, while simultaneously pursuing a limited and predominantly non-military agenda. Furthermore, researching the Russian hybrid war is also important because one cannot exclude the possibility that other major powers will learn and adopt the methods developed by Russia, or that they will use these instruments in their own perceived zones of influence, in East Asia, for example. All in all, even though the conflict in Ukraine has since transitioned into a conventional war, hybrid warfare still constitutes an important topic for researchers due to its continuously relevant practical implications.

VOLODYMYR SIDENKO

## UKRAINE'S TRANSFORMATION CHALLENGES IN THE FRAMEWORK OF ASSOCIATION WITH THE EU AND THE CONFLICT WITH RUSSIA

More than one year has elapsed since the dramatic political events in Ukraine in February 2014. Ukraine's new leaders confronted with serious challenges. The successful management of these problems may turn out to be vital for the country's integrity and survival as an independent state. These challenges, despite their diverse manifestations, could be summarised as the country's urgent need to transform itself under the extremely unfavourable conditions of increasing internal imbalances and shortages, critically exacerbated by the ongoing conflict with Russia. Unfortunately, so far on its way to Europe and despite its pro-European transformation Ukraine has had rather limited and ambiguous results. That is why it is necessary to try to derive some lessons from the period since February 2014, to summarise the characteristics of the present internal and external state of Ukraine's economy, and thus evaluate the possible future developments and outcomes for Ukraine.

### **From February 2014 to February 2015: the year of losses and lost opportunities**

In February 2014, during the triumph of the Ukrainian "Revolution of Dignity", many Ukrainians (especially in the more pro-European western and central regions of the country) expected the near advent of fundamental economic and social transformations that had been outlined within the draft of the Association Agreement (AA) with the EU. A year later, public perception of the progression this path looks disappointing. There are multiple evidences of this including attitudes in different opinion polls, interviews with prominent public figures (both inside and outside Ukraine), reports of various experts and think tanks, and different international organisations. However, I would refer here merely to two polls carried out by Razumkov Centre Sociological Service on 16-21 January and 6-12 March 2015<sup>1</sup>.

The January 2015 survey<sup>2</sup> exposed the prevailing attitude (38.1 percent of respondents) holding the view that there are no real reforms, only their imitations. 16.0 percent of respondents denied even the fact, that reforms had been imitated, 30.6 percent supported the view that there had been some steps towards implementing reforms. Only a minor

<sup>1</sup> The surveys were performed in all regions of Ukraine, except Crimea in the first case and Crimea plus occupied regions of Donetsk and Lugansk regions in the second case. The surveys covered 2012 and 2009 respondents (aged 18 years), respectively. The theoretical sampling error of the survey did not exceed 2.3 %, with statistical probability equal to 0.95.

<sup>2</sup> This is the original publication of these data.

2.7 percent believed in radical transformations in economic and social spheres. The average mark that Ukrainian reformers received from the Ukrainian population was 2.75 from the potential 10.0, with the quarter (25.7 %) of the population putting the lowest mark (1).

The March 2015 survey<sup>3</sup> found that the Ukrainian population ranked the achieved progress in reforms in different areas extremely low: on a 10.0 scale, reforms in the sphere of judiciary received 2.39, decentralization and local government – 2.53, governance – 2.44, deregulation and entrepreneurship development – 2.27, law protection system – 2.60, health care – 2.23, taxation – 2.38, agriculture – 2.15, education – 2.35, and financial sector – 2.12. The lowest marks (on the 5.00 scale) received the measures taken to fight corruption (1.82), fostering economic growth (1.69), and suppressing inflation (1.60).

The above-presented estimates are actually the evidence that *the potential political impulse of February 2014 has not been transformed into an impetus of socio-economic change*. Instead of the expected swift and radical transformation in the economic and social domains, Ukrainians face a slow and protracted process of changes, Even this was in a sharp contrast to the inertia of the regime prior to 2014 . A number of factors, which were quite diverse in their nature, determined this course of events.

First, we account for the *severe internal political turmoil and military actions* that followed the February 2014 change of political power. The Russian annexation of Crimea coupled with the prolonged Russian intervention to support the local separatists in Eastern Ukraine (Donbass), incurred a substantial damage on Ukraine's economic potential. Thus, according to the official estimates of the government of Ukraine from February 2015<sup>4</sup>, Ukrainian losses and costs resulting from the lost territories and war destructions comprise:

- *The destruction of 20% of Ukraine's economic potential*, including its forecasted revenues and foreign exchange earnings.
- *Considerable current financial losses*, including:
  - extra defence spending from the state budget of around UAH 100 million daily in order to protect itself;
  - The loss of budget revenues in 2014 of about UAH 23 bn (Crimea and the city of Sevastopol – UAH 9.8 bn; Donetsk and Luhansk regions – UAH 13.2 bn);
  - Tax revenues' reduction for the mandatory state social insurance schemes – UAH 13.2 bn (including UAH 6.5 bn in Crimea and Sevastopol, and UAH 6.7 in the East of Ukraine).
- *Long-term economic and infrastructure losses* comprise:
  - The estimated value of the financial losses due to illegal confiscation of

<sup>3</sup> Razumkov Centre (25 March 2015).

<sup>4</sup> Government of Ukraine (2015).



property of more than 4,000 enterprises in Crimea is about UAH 1,180 bn or about USD 74.9 billion<sup>5</sup>

- In the Donetsk region, the warfare destroyed or damaged about 12 percent of all residential structures and over 1,000 energy infrastructure objects; the total value of destroyed and damaged property (including communal property and social infrastructure) amounts to UAH 1,25 bn.
- The *breakdown or substantial impediments to traditional production chains* “coal-coke-metal” and “coal-electricity” have led to a drop in production due to shortages in raw material supplies, decreased the exports of finished goods. The damage in industrial and infrastructure facilities, water supply and power systems and the suspension of banking operations further exacerbated the already severe situation.
- Tremendous *loss in human potential*: 978,482 Ukrainians (as of February 2, 2015) had to flee from the „temporarily occupied territories”<sup>6</sup> and are currently registered as internally displaced persons.

According to preliminary estimates<sup>7</sup> prepared by a group of international experts made in February 2015, 3.9 million people have been severely affected by the conflict, while 5.2 million were living in conflict-affected areas.

No doubt, that the above-mentioned figures of losses testify a substantially limited capacity to develop the economy and implement the needed structural transformations. However, not merely the *direct* losses incurred by the warfare account for the decreased economic capacity. Perhaps, the *indirect* effects associated with the *extremely high entrepreneurial risks* and *sovereign default risks* coupled with the *diversion of not only financial but also organisational resources* from the long-term targets of institutional reforms to the current objectives of military resistance and survival play no smaller significance.

In the course of the Russian-Ukrainian conflict, Russia has demonstrated its potential of extensive use of various *economic policies specially targeted at destabilising Ukraine's economy*. Obviously, these Russian measures have not only decreased the Ukraine's overall potential to resist the external political and military pressure; what is even more important, they served to ignite an internal political and social discord.

In this context, *Russia has deployed a vast set of various restrictive practices in the field of commercial relations*. These have already caused a sharp deterioration in the domain of mutual trade. In 2014, Ukraine's exports of goods and services to Russia showed a \$5 billion (33.7 %) and \$1.7 billion (33.0 %) slump respectively. On the other

<sup>5</sup> In USD terms valid for the period of the relevant calculations (UAH 15.76 for 1 USD).

<sup>6</sup> This refers to Eastern Ukrainian conflict zones in the official Ukrainian documents. (editor's comment)

<sup>7</sup> Delegation of the EU in Ukraine, the UN and the World Bank (February 2015).

hand, Russia's exports of goods decreased by \$10.4 billion (45.1 %), with exports of services losing \$359 million (29.1 %) in the same period. It is peculiar that the commodity positions and items prioritized earlier turned out to be among the most vulnerable ones (see Table 1).

**Table 1.**  
Commodity groups in Ukraine's export to Russia, which suffered relatively bigger losses because of Russia's restrictive and discriminatory practices

Commodity group	Share in aggregate exports of goods in 2013 and 2014 (percent)	Decrease in the value of exports as compared to 2013 (percent)
Articles of apparel and clothing accessories, not knitted or crocheted	0.1/0.1	31.4
Ceramic products	1.3/1.4	32.0
Tools, implements, cutlery	0.1/0.1	32.4
Vehicles other than railway	1.3/1.3	32.6
Copper and articles thereof	0.5/0.5	32.7
Iron and steel	14.3/14.6	33.3
Preparations of meat, of fish	0.3/0.2	35.5
Aluminium and articles thereof	0.2/0.2	36.2
Carpets	0.1/0.1	37.7
Electrical machinery and equipment	7.3/6.9	38.1
Other made up textile articles	0.1/0.1	38.2
Articles of stone, plaster, cement	0.5/0.5	40.0
Plastics and articles thereof	2.6/2.4	40.5
Rubber and articles thereof	0.4/0.3	41.4
Articles of apparel and clothing accessories, knitted or crocheted	0.5/0.4	43.5
Animal or vegetable fats and oils	0.4/0.3	49.1
Beverages, spirits and vinegar	1.5/0.9	53.4
Organic chemicals	0.6/0.4	53.6
Preparations of vegetables	1.2/0.8	54.6
Meat and edible meat offal	1.1/0.7	55.5
Cereals	0.2/0.1	56.2
Railway locomotives	11.6/6.1	63.4
Cocoa and cocoa preparations	2.2/1.2	63.7
Dairy produce, birds' eggs and natural honey	2.2/1.2	68.1

Commodity group	Share in aggregate exports of goods in 2013 and 2014 (percent)	Decrease in the value of exports as compared to 2013 (percent)
Sugars and sugar confectionery	0.5/0.2	71,7
Oil seeds and oleaginous fruits	0.6/0.2	75.5
Miscellaneous	0.2/0.1	75.6
Ships, boats and floating structures	0.3/0.0	89.0
<i>Total of the groups mentioned</i>	<i>52.2/41.3</i>	

*Source: Author's calculations based on the data: State Statistics Service of Ukraine. Exports and Imports of specific goods by countries, 2013-2014 (in Ukrainian).*

Thus, during the past one year Ukraine faced Russia's intensive restrictive trade measures. They included a ban or "suspension" of imports of a wide range of products, like milk and dairy products (especially cheese products), pork, canned vegetables and fish, juices, potato, sunflower, the confectionary products *Roshen*, *AVK* and *Conti* (*Roshen*, *AVK Company* and *Conti* brands), the output of certain beer-producing companies (*Obolon*, *SUN InBev Ukraine*, with its *AB InBev* trade mark), as well as a ban imposed on the flights performed by Ukrainian airlines through the Russian territory.

At the same time, Russia's losses in Ukraine's market comprise primarily the collapse (−53.2 %, amounting to \$7.7 bn) in energy supplies. Other items with considerable decrease are iron and steel (−46.6% or \$379 million), nuclear reactors, boilers, machinery and mechanical appliances (24.1 % or \$297 million), electrical machinery and equipment (−35.0 % or \$273 million), (−21.8 % or \$131 million), plastics and articles thereof (−25.3 % or \$124 million). For Ukraine, these developments had a rather mixed effect associated not only with necessary reorientation of external connections but also with more stringent conditions of energy supplies and suspension of industrial co-operation.

However, these already implemented destructive trade policies are only an introduction to the upcoming, larger scale trade restrictions to be imposed by Russia when the Deep and Comprehensive Free Trade Agreement (DCFTA) between Ukraine and the EU enters into force. On September 19, 2014 the Russian government adopted a regulation<sup>8</sup> that provides for an exclusion of 174 commodity groups and items from the free trade regime, effective according to the relevant CIS free trade agreement. These restrictions may cover foodstuffs, clothes and accessories (?), chemical products, iron and steel, machinery and equipment, construction materials etc. These new restrictions have been temporarily suspended since the DCFTA provisions of the Association Agreement were postponed until the beginning of 2016. Nevertheless, they are due to come into effect in any moment, even upon alleged accusations that provisions of the DCFTA are "actually implemented".

<sup>8</sup> Government of the Russian Federation (19.09.2014).

New trade restrictions are also likely to be introduced in the field of transportation services. Russia still strives for finding routes bypassing Ukraine – a politically motivated effort under the propagandistic slogan, labelling Ukraine as “unreliable transit provider”<sup>9</sup>.

In addition, Russia declared restrictive measures against Ukrainian labour migrants by introducing for them, a general regime based on work patents and strengthened control over the term of stay on the Russian territory (no more than 90 days) from January 2015. According to some estimates, it may cause a 20-30 per cent decrease in Ukrainian labour migration to Russia<sup>10</sup> and expected losses in incomes around \$11–13 bn<sup>11</sup>. Apart from this, taking into account the considerable amount of external transfers made by Ukrainian migrant workers (\$5.2 bn, as indicated in Ukraine’s BoP for 2014)<sup>12</sup>, one may expect new Russian regulations to impose additional control over transfer of incomes from Russia to Ukraine, formally justified by the slogan of “fighting international terrorism or money laundering”.

Russia retains significant level of influence in Ukraine’s financial sector. Four Russia-controlled banks (*Prominvestbank* controlled by *Vnesheconombank (Moscow)*, *Sberbank of Russia*, *ALFA-Bank Ukraine*, and *VTB Bank*) are among 15 biggest banks in the Ukrainian market (referred to by the National Bank of Ukraine as Group 1 of banks). These Russian banks account for 18 percent of aggregate capital, 21 percent of authorized capital and over 20 percent of loans granted by the Group 1 banks<sup>13</sup>. It is noteworthy that within the period of sharp decline in commercial transactions between Russia and Ukraine in 2014, the overall value of aggregate capital assets of the Russian banks in Ukraine have grown by almost 25 percent, and the value of their loans granted – by 31 percent.

These banking instruments are also augmented by the outstanding Russian influence over the Ukrainian stock markets, because two most important stock exchange platforms – *PFTS* and *Ukrainian Exchange* are actually subsidiaries of the *Moscow Stock Exchange*.

With these instruments at their disposal, Russia has *vast opportunities to influence internal processes in the monetary sphere of Ukraine*, via shaping demand on internal markets, exerting impact on the velocity of money circulation and capital instruments and on the terms of settlements of commercial contracts. These measures might be easily supported by means of informational warfare via the Russia-controlled media spreading rumours and negative predictions, in order to ignite distrust and panic behaviour. The latter aspect is obviously the strongest instrument of Russia’s aggressive policies in its mix of the so called “hybrid warfare”. We have already witnessed the grave

<sup>9</sup> The Russian Premier D. Medvedev (December 2014) warned about such prospects quite overtly.

<sup>10</sup> Zmanovskaya A. (December 2014).

<sup>11</sup> Medvedev D. (December 2014).

<sup>12</sup> NBU. Statistics of the external sector. Balance of payments.

<sup>13</sup> Author’s calculations based on financial reporting of Ukraine’s commercial banks in the NBU.

results of this sort of actions in the form of an attack against the Ukrainian national currency (hryvnia, UAH), which suffered an unprecedented devaluation since mid-1990s (between January 2014 and February 2015 the average official monthly rate of UAH to USD floated in the range of 7,993 to 24.4799<sup>14</sup>). These developments have led to huge macroeconomic disparities within the economy, seriously inhibiting the normal course of activities and making the bulk of existing commercial transactions unprofitable or unviable in market terms.

Despite the shrinking mutual interactions, Russia preserves substantial control over the production chains in a number of key industries in Ukraine, including nuclear power production, aircraft and space rocket industry. Thus, Russia has certain instruments at its disposal to incur further grave losses on the real sector of Ukraine's economy, to let the production cycles at large-scale enterprises suspended, causing factory closedowns or unpaid leaves for workers, triggering payment and solvency problems. Such restrictive policies may result in a slump of the market value of Ukraine's leading companies, which would seriously inhibit their necessary restructuring and may result in subsequent hostile acquisitions or squeezing them out of the market.

Russia has already embarked on a policy to relocate certain Ukrainian production facilities of its special interest onto its own territory, especially in the field of defence industries and aircraft production. These actions are the most evident in the temporarily occupied territories of Eastern Ukraine, and may further progress and proliferate, if economic crisis inside Ukraine deepens.

*The above-described circumstances leave no other chances for Ukraine than to reform its entire economic system and enable its restructuring in a way that provides much lesser dependence on the Eastern "partner". This is essential for the purpose of the country's economic security, which is certainly of no lesser significance than the matters of economic efficiency. Nevertheless, even under the extreme conditions of the hybrid warfare Ukraine cannot allow itself full suspension of economic ties with Russia. This would be detrimental to the Ukrainian economy, which has already been exhausted by the deep structural crisis. This might cause its collapse instead of its managed transformation.*

#### **New pro-European opportunities and stumbling blocks in the way**

The year 2014 brought about the restructuring of almost all the aspects of Ukraine's external economic exchanges in favour of the EU. The share of EU-28 member states in Ukrainian exports of goods and services reached 31.5 and 34.5 percent<sup>15</sup> respectively, while the share of Russia fell to the points of 18.2 % and 31.5 percent. In Ukrainian

<sup>14</sup> The February 2015 devaluation was especially outstanding, with the UAH rate rising by 55 % as compared to the previous month.

<sup>15</sup> These and other figures presented later in this article in the context of EU-Ukraine trade and investment relations are based on official data of the State Statistics Service of Ukraine.

imports, the level of dependence on the EU market is much higher – 38.7 % and 51.9 %. In the area of foreign direct investment, the share of the EU in the total FDI stock as of the end of 2014 amounted to 77.3 percent, with Russian holdings of merely 5.9 percent<sup>16</sup>. These increments in the relative shares might look as a direct result of the agreed and signed (in September 2014) Association Agreement and the autonomous EU trade preference with regard to Ukrainian goods employed since April 2014<sup>17</sup>. However, in fact the positive influence of these events is only partial and hides the rather ambiguous reality. The latter has a number of negative developments and vulnerabilities that has to be taken into account.

First, the initial evaluation of the possible positive impact of the EU's autonomous trade preferences, which predicted an annual gain for Ukraine's exports of € 487 million<sup>18</sup> (equivalent to €325 for the period of May-December 2014), fell far short of this. The actual gain in goods exports to the EU-28 was only around €186 million (a minor 1.5 percent growth as compared to 2013), mainly as a result of deceleration of Ukraine's export growth to the EU's market at the end of 2014. That was predetermined by the concentration of the export mainly to the agricultural products, more specifically – mostly to grain, oilseeds and oils (see Table 3). This sector in many regards exempted is from the free trade regime due to the high number of exclusions, in particular in the form of tariff quotas.

Second, the trade between Ukraine and the EU moved on a downward trajectory resulting in a 22.3 % fall in Ukraine's import of goods and 30.7 % fall in import of services from the EU; likely explanation for this drop is the above-mentioned radical devaluation of the Ukrainian currency that made imports much more expensive. However, the services export also showed a decrease of 9.5 % that demonstrated the shrinking role of transit transportation to Europe from Ukraine's eastern neighbour.

Third, trade flows tend to be heavily concentrated on a rather limited spectre of partner countries (Table 2) and commodity groups (Table 3). Both of these characteristics testify the limited competitiveness of Ukrainian companies in the EU market, and both of them make possible sharp fluctuations in trade flows, rendering them to intrinsic instability.

<sup>16</sup> Of course, this figure seems to be much lower than the actual level of Russian control over Ukrainian assets, as ownership control is often performed in a hidden form through Ukrainian nationals.

<sup>17</sup> European Parliament and of the Council (2014). In October 2014, the term of validity of the regime provided by this regulation was extended until the end of 2015. Thus, the EU suspended about 98 % of its import duties for goods originating in Ukraine.

<sup>18</sup> European Parliament (March 2014).

**Table 2.**  
**Concentration of EU-Ukraine's trade flows: share of EU main trading partner countries**  
**in Ukraine's exports and imports to EU-28 in 2014 (%)**

	POL	ITA	GER	HUN	ESP	NLD	GBR	CYP	AUT	FRA	LTU	6 leading partner countries
Export of goods	15.6	14.5	9.4	8.9	6.9	6.5						<b>61.7</b>
Import of goods	<sup>1</sup> 4.6	7.2	25.5	7.0						6.0	4.9	<b>65.0</b>
Export of services	5.1		16.5			7.2	16.5	11.6	5.1			<b>62.1</b>
Import of services	4.9		16.4			4.3	23.3	16.6	5.4			<b>70.9</b>

Source: Author's calculations based on the data: State Statistics Service of Ukraine. Exports and Imports of specific goods by countries.

**Table 3**  
**Concentration of EU-Ukraine's trade flows: share of some commodity groups in Ukraine's**  
**goods exports to EU main trading partner countries in 2014 (%)**

Commodity groups	POL	ITA	GER	HUN	ESP	NLD
Agriculture products and food stuffs (groups 1-24 HS), incl.:	20.4	25.2	15.3	3.3	79.2	67.7
<i>Cereals (10 HS)</i>	0.6	11.8	5.4	0.2	53.2	28.5
<i>Oil seeds and oleaginous fruits (12 HS)</i>	2.8	3.4	4.4	2.0	3.0	12.3
<i>Animal or vegetable fats and oils (15 HS)</i>	2.3	6.7	0.2	0.3	16.1	15.1
Iron and steel (72 HS)	23.1	55.6	6.8	25.3	5.2	16.6
Machinery, equipment and instruments (groups 84-90 HS), incl.:	14.8	1.1	30.2	39.8	1.8	4.2
<i>Electrical machinery and equipment (85 HS)</i>	11.9	0.3	20.8	37.9	0.9	1.7

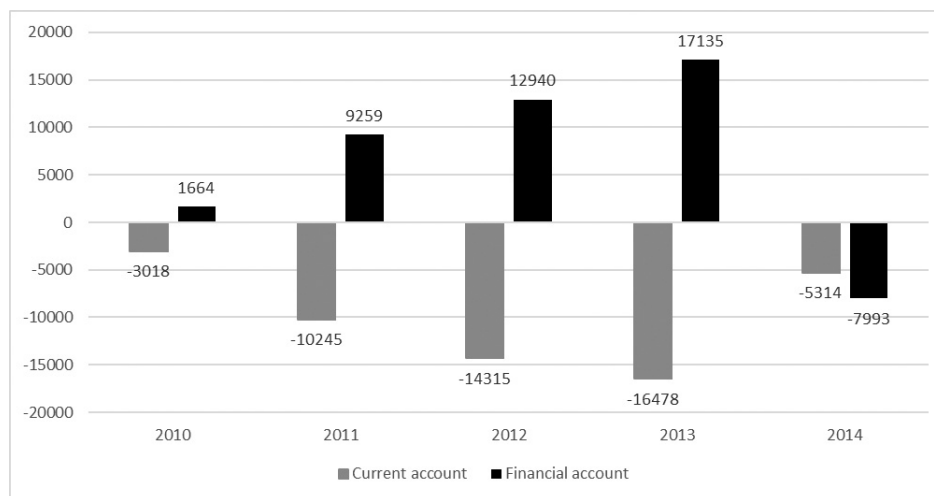
Source: Author's calculations based on the data: State Statistics Service of Ukraine. Exports and Imports of specific goods by countries.

Despite all the significance of the EU's autonomous trade preferences, the €11.17 mn indicative package of financial assistance declared by the European Commission in March 2014<sup>19</sup> and €1.6 bn actually disbursed in EU loans and grants in 2014<sup>20</sup>, failed to avert the overall worsening of the economic situation in Ukraine. The latter is characterised by a *unique combination and mutual amplification of various imbalances*.

<sup>19</sup> European Commission (March 2014).

<sup>20</sup> European Commission and High Representative of the European Union for Foreign Affairs and Security Policy (March 2015). One should note in this context the EU's State Building Contract and Macro-Financial Assistance programmes being implemented in Ukraine.

1. We witness the combined presence of both *internal* and *external* imbalances. The former is represented by the high levels of fiscal deficit<sup>21</sup> and inflationary pressures<sup>22</sup> under the already recessionary trend regarding the country's GDP<sup>23</sup> and the decreasing output in major sectors of the economy, except agriculture<sup>24</sup>. The external imbalances manifest themselves through the growing deficit in the Balance of Payment (Fig. 1) and the rapidly disappearing international reserves (Fig. 2) which happens in a situation, when the country faces a critical situation in imports of energy supplies.



**Figure 1. Changes in Ukraine's BoP current and financial accounts, 2010-15**

Source: NBU statistics. Statistics of the external sector. Balance of payments.

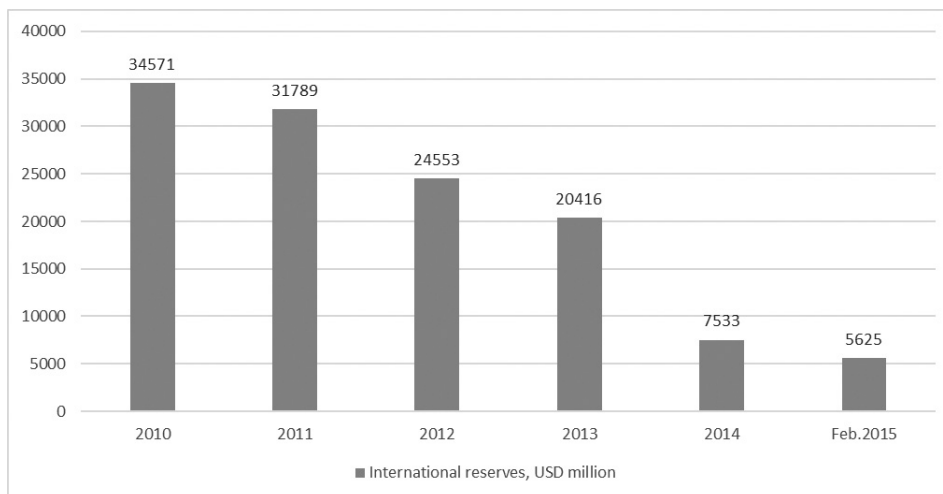
<sup>21</sup> The aggregate fiscal deficit of the central government, includes not only the state budget itself but also quasi-fiscal deficits of major state-owned agencies and companies (NAFTOGAS and State Pension Fund are the main debt "contributors"). This aggregate exceeded the level of UAH 78 billion, which was 18.2 percent of the state budget expenses. See: NBU Bulletin (January 2015).

<sup>22</sup> December 2014 CPI was 124.9 % to the level of December 2013, with January 2015 adding another 3.1 percent. See: NBU Bulletin (January 2015).

<sup>23</sup> Ukraine's GDP demonstrated a trend towards deepening recession through the whole year of 2014: in comparative prices of 2010, the fall against the similar period of 2013 was 1.2 % in the first quarter of 2014, and 4.5 %, 5.4 % and 14.8 % – in the second, third and fourth quarters, respectively. See: State Statistics Service of Ukraine. The change of GDP volumes.

<sup>24</sup> While in industry the fall of output in 2014 reached 10.7 %, agriculture produced a surplus of 2.8 %. See: State Statistics Service of Ukraine. Main indicators of socio-economic development of Ukraine.





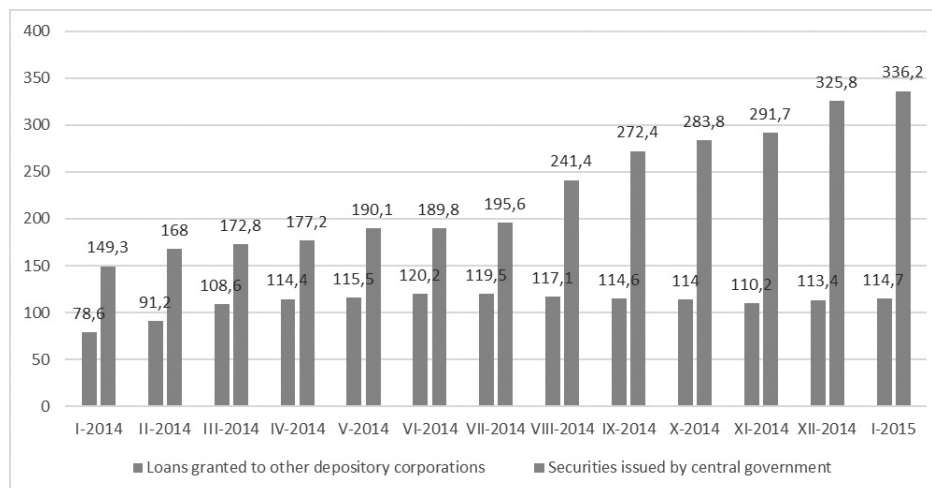
**Figure 2. Changes in Ukraine's international reserves, 2010-15**

Source: World Bank database, NBU statistics. Statistics of the external sector. International reserves.

2. In the financial sector, which has become the bugset of the spreading economic crisis, we see the *combined crisis of the banking sphere and state finances*. As of March 5, 2015, 36 Ukrainian commercial banks had been declared insolvent and placed under the procedure of liquidation; another 9 banks had completed the liquidation procedure since February 2014. The total number of financial institutions in Ukraine dropped from 180 to 155 between January 2014 and February 2015. The remaining commercial banks accumulated substantial arrears and suffered significant losses equal to UAH 53 bn in 2014 and UAH 8.5 only in January 2015<sup>26</sup>. Of course, they desperately need refinancing from the Central Bank (NBU) that expanded its balance in the midst the general credit crunch in the economy. In this urgent situation, the NBU provided substantial and highly selective financial support to some commercial banks – a policy which, in fact added much to the general inflationary pressures and the destabilisation of the Ukrainian currency, not to say about widespread accusations of misusing public funds on the part of the central bank.

However, since mid-2014, the principle target of the NBU support was not the banking sector but the central government budget (Fig. 3). In fact, the NBU steadily increased hryvna supply in order to cover the growing expenses of the state budget.

<sup>25</sup> NBU. Main Indicators of the Activities of Banks in Ukraine.



**Figure 3. Specific dimensions of the NBU's monetary policy: growth of some monetary assets components since January 2014, bn UAH**

Source: Bulletin of the National Bank of Ukraine (electronic edition). Table 3.1.1.

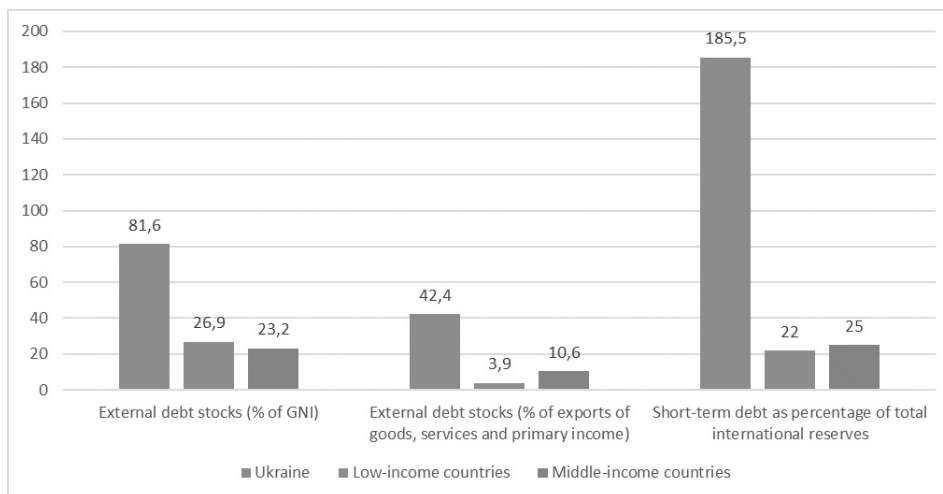
3. In the external balance (BoP), Ukraine faced an unprecedented situation of a twin deficit, *simultaneous deficits of current and fiscal accounts*. As we can see from Fig. 1, Ukraine's external imbalances had been present much earlier but the situation deteriorated in 2014. The inflow of external capital and foreign loans could no longer cover the huge gap in the current account any longer. On the contrary, capital movements had a negative effect on the account. In the situation of political instability and growing uncertainty, Ukraine encountered the problem of capital flight and the inability to refinance its maturing foreign-currency denominated bonds as a result of a series of credit rating downgrades.

The adverse combinations of these factors hindered the viability of the stabilisation policies, *leaving actually no room for macroeconomic policies* and placing the country's economy in downward spiral *without the permanent infusion of external capital*. However, the trouble does not come alone. In this regard Ukraine faced a rather peculiar situation in 2014 when it had to pay-off its earlier issued foreign debts, thus *the overall balance of external financial flows turned to be negative*: the overall inflow of external loans and financial assistance in 2014 amounted to \$9 bn while the value of pay-offs exceeded \$14 bn<sup>26</sup>.

However, these above mentioned characteristics of the external financial drain were not a surprise for experts. In fact, this was a logical consequence of a *long-term policy*,

<sup>26</sup> UNIAN Information Agency (2 December 2014).

*comprising of large-scale borrowing from abroad for unproductive purposes (that is without creation of a source for a subsequent pay-off), and thus the creation of the model of expanding consumption by accumulating foreign debt. Fig 3 demonstrates the disastrous results of this political course, as Ukraine has placed itself far above the average levels of sustainable indebtedness that one can find in countries with low and medium levels of income.*



**Figure 4. Relative levels of foreign indebtedness of Ukraine as compared to average levels of low and medium income countries of the world, 2013**

*Source: World Bank International Debt Statistics database; for short-term debt – author's calculations based on the data contained in the database.*

Overall, the above-mentioned deficiencies can be regarded as a direct outcome of a process, in which reforms are implemented by a much slower pace than the abolishment of the old and already dysfunctional system.

This does not mean that no attempts have been made to reform the country and its economy. In fact, the EU authorities in their conclusions to “Ukraine’s implementation of its commitments on Eastern Partnership”<sup>27</sup> admitted Ukraine’s “overall good progress on deep and sustainable democracy, on human rights and fundamental freedoms”, including the issues of elections, prosecutorial reform, adopted (though not yet duly implemented) anti-corruption legislation, and visa liberalisation (meeting the benchmarks in the Visa Liberalisation Action Plan). However, the transformation of the socio-political framework is still largely impeded due to delays in judicial and law enforcement reforms.

<sup>27</sup> European Commission and High Representative of the European Union for Foreign Affairs and Security Policy (March 2015).

In the area of economic transformation, Ukraine made, according to the mentioned EU estimates, “some progress” on deregulation (reducing the number of business licences and permits, institutional restructuring of the system to promote small and medium business) coupled with bringing the legislation on state aid closer to comply the EU state aid standards. Amendments in consumer protection legislation aimed to remove unnecessary administrative restrictions hindering trade and competition. Legal acts were also adopted in certain (rather limited) areas of fiscal decentralisation (i.e. real estate tax and a fixed agricultural tax from now are locally collected) and on better regulation of financial services, including regulations on the disclosure and free access to information about banks’ ownership, stricter requirements for corporate governance of banks. Some progress was registered in the area of harmonisation of Ukrainian food legislation with that of EU’s (laws on food safety and animal identification and registration. A number of further measures are on their way). Several revenue-consolidating measures were introduced in the sphere of government finance and taxation, including higher royalty rates on oil, gas and metal extraction, the issue of VAT bonds to refund value-added tax refund arrears, and the introduction of a new system of electronic VAT administration (though not yet fully operational), revision of the social contribution tax and personal income taxation system (i.e. excluding earlier existing benefits regarding incomes received from banking deposits or securities). A number of improvements were made in Ukraine’s public procurement legislation.

Nevertheless, the list of failed or unfinished reform attempts is striking, and in some regards, the government even made a retreat from the earlier declared principles of reforms. Among others it introduced new trade restrictive measures (including a special import duty) that made many essential imported products excessively expensive while the reform of the customs authorities stopped. The EU experts indicate only minor progress in the areas of company law, corporate governance, accounting and auditing. The new version of the public procurement law (as of April 2014) is still not fully compatible with the EU legislation. The reform of the public finance management has been delayed, with actually no visible progress on increasing state budget transparency. In fact, there has been no real simplification of the taxation system, what remained burdensome for business. In addition, various state-controlled natural monopolies remained highly inefficient and they misuse resources. In this context, the situation in the energy sector is very indicative, where Ukraine has been failing to implement many of its commitments taken within the Energy Community.

Of course, the Ukrainian government *is on the track of a reform policy*, but it is *unacceptably slow*. *The implementation seems to ignore the vital significance of the limited time frame at disposal*. That is why these policies are widely perceived as no reforms at all.

**Possible future scenarios for Ukraine and its Eurointegration course**

Taking into account the above-mentioned predicaments, the EU's policy towards Ukraine is now targeted at *fostering substantial acceleration and broadening* of the pro-European transformation process in line with the provisions agreed under the Association Agreement. With this aim, a new revision of the EU-Ukraine Association Agenda<sup>28</sup> took place during the March 2015 session of the EU-Ukraine Association Council.

The priority measures outlined by the EU<sup>29</sup> concentrate, in particular, on the following issues:

- due implementation of the comprehensive anti-corruption legal package (as of October 2014), with effective functioning of the National Anti-Corruption Bureau and the National Agency for the Prevention of Corruption;
- improving transparency and competitiveness in public procurement in line with the EU Public Procurement Directives;
- starting comprehensive reform of the public administration, and in particular of the civil service and service in local administrative authorities focusing on European principles of public administration;
- implementing laws for decentralisation reforms;
- aligning energy legislation and practice with the 'Third Energy Package';
- reducing the regulation for businesses and improving the efficiency of the tax administration;
- developing external audit function to strengthen the system of checks and balances;
- continuing reforms to public finance management, in particular in the areas of strategic budgetary planning, introduction of budgetary rules, forecasting, prioritisation of investment projects, public procurement, internal control and internal audit and budget transparency.

However, despite all the significance of this reformulation of priorities for reforms, the most difficult questions from the list above are still left without response. As a matter of fact, in its relations with Ukraine the EU (and earlier European Communities) have proceeded from a rather simplified institutional approach. EU leaders and European Commission officials regard the success in reforms primarily as a matter of *political will* to implement a vast package of institutional amendments backed by EU finances and Ukrainian access to some EU programmes. These conceptual patterns are supported by pro-European Ukrainian intellectuals and civil activists, who are even more straightforward: Association Agreement is a guarantee for Ukrainian modernization and access to the European funds, enabling smooth implementation of needed reforms, similar to other former candidates of the earlier waves of EU enlargement process. However,

<sup>28</sup> EU-Ukraine Association Council (March 2015).

<sup>29</sup> See: European Commission and High Representative of the European Union for Foreign Affairs and Security Policy (March 2015).

those people who really rule the country, representatives of a symbiosis of business elites and government bureaucracy – are extremely pragmatic. For them European values and humanitarian aspects that enable efficient long-term development are merely rhetorical instruments to raise public support. What they really appreciate is *money*, and therefore they favour, in their integration policy considerations, a sort of a utilitarian, *bookkeeper's* approach regarding the *balance of monetary-fiscal gains and liabilities*, preferably within their short-term outlook.

Extremely indicative of this prevailing Ukrainian mode of thinking about European integration is the very fact that the previous Ukrainian regime suspended preparations of the signing of the Association Agreement in Vilnius in November 2013 on the basis of purely monetary calculation<sup>30</sup>. However, this sort of methodological approach one could notice in a number of research papers published before the finalisation of the AA that were rather cautions about possible future outcomes of its implementation<sup>31</sup>.

The core of the problem with the Ukrainian reforms is not the misunderstanding of what and when must be done, or what price has to be paid for social changes. The most significant factor that decelerates the reforms is the inertia of the old social patterns, which are, despite their obvious fundamental structural deficiencies, deeply rooted in *informal* institutional arrangements. These arrangements reflect the prevailing and persisting *mode of thinking and the culture of social behaviour*, in which the notion of the state is associated not so much with the role of an *arbitrator* in a game between free and socially responsible private actors, but as the *main player itself*. That is why the advent of a “capitalist economy” in Ukraine rested not so much on the privatisation of *economic assets* but primarily on the *privatisation of the state and the governmental mechanisms*, made through formally democratic (in fact, quasi-democratic) procedures. The country’s European perspectives strongly depend on the ability to *comprehend and correct this outlook and attitude* inherited from the past.

In this context, the new IMF EFF programme of financial rehabilitation of Ukraine, which promises, apart from a direct IMF loan of about \$17.5 bn, the overall infusion of \$40 billion into Ukraine, looks highly appropriate from the macroeconomic point of view but the impact on deep structural reforms is rather questionable. The latter needs money and time, none of which Ukraine has obtained so far. Moreover, in the absence of considerable private capital inflows, the IMF-shaped policies of monetary and fiscal

<sup>30</sup> The former president of Ukraine summarized it in mid-November 2013 as \$100–500 bn “needed to modernize the Ukrainian economy according to EU standards”. These figures served as a pretext to demand “compensation” from the EU for the “losses” stemming from the AA. See: Serguey Sidorenko (2013), p.1.

<sup>31</sup> See, for instance: V.M. Heyets, T.O. Ostashko, and V.O. Tochylin (2013). Though this research paper contained some useful in-depth analytical findings based on vast empirical analysis, its overall philosophy resting on mercantilism and protectionism is questionable and, objectively, it provided ground for further politically motivated conclusions against AA, instead of taking timely measures to prevent or diminish potential adverse effects of this agreement.

tightening would make the problem even more difficult to tackle. The recent Greek experience might be a convincing evidence of this. This is why so much depends on the ability of Ukraine to attract private investments needed for deep structural transformations.

However, attracting substantial private capital and FDI needs, as a precondition, the *comprehension of the significance of swiftly developing institutional reforms* that could arouse from substantial business interest. Nonetheless, the latter might be seriously handicapped because of the growing *internal discord* among the ruling coalition and the *lack of constructive communication* between the government (in the broader sense of all branches of power) and the civil society. The growing distrust<sup>32</sup> and negative expectations<sup>33</sup> on the part of the latter are signs of *potential significant political changes in the near future*. Here, we can foresee three possible scenarios of future developments in Ukraine, each of them having profound potential geopolitical/geo-economic outcomes and impact on the future relations of the EU and Ukraine.

*Scenario 1: Restoration.* The growing economic hardships stimulate political reorientation of the society that may, under certain conditions, repeat its former political experience of bringing back the government of former “regionals” into power (ex-members of the Party of Regions reshaped in a new political format, currently represented by the so-called Opposition Bloc). This has already happened in the past, after the Orange Revolution in 2005. The viability of this scenario rests on the actual control of many of the economic “commanding heights” by ex-“regionals” and over the bulk of their offshore financial assets, as well as their actual penetration into the currently ruling political structures. No doubt, their main external sponsor would be Russia.

However, this model would not offer the society other option than a higher level of centralisation and state control – actually a new version of an authoritarian rule, supplemented by a relief from Russian “hybrid war” pressure and even some Russian economic concessions. Perhaps this scenario also would include a partial revival of mutual trade at the expense of much easier access to Ukrainian assets for Russian capital. These steps might confine temporarily the most painful manifestations of the deep and comprehensive crisis inside Ukraine. But they are principally unable to solve the most urgent, crucial problems of the country. This scenario constitutes a blind street for the country, and would put Ukraine in a marginal position in Europe and worldwide, and moreover, in the Eurasian area as well. All in all, it might be a prelude for subsequent political disintegration of Ukraine under the pressure of irreconcilable internal contradictions.

*Scenario 2: Radicalisation.* The mass deprivation of large groups of the population is

<sup>32</sup> Razumkov Centre (2015), p. 53-55.

<sup>33</sup> Razumkov Centre (March 2015) in its survey revealed that 57.4 percent of the population are expecting further deepening of the economic crisis in 2015, and 30.7 % predict an economic collapse, with mass lockouts and unemployment, default on debt servicing, and depreciation of the national currency. 53 % of Ukrainians are already (most of the IMF recommended cuts have not been felt yet) not ready to endure further cuts in living standards and material hardships.

always accompanied by the advance of once marginal political forces with radical political platforms. In case of Ukraine, this potential turn might be primarily associated with a rise of extreme nationalistic attitudes. Combined with a kind of pro-socialist (or perhaps quasi-socialist) orientations, they might mean further centralisation (both political and economic), erosion of personal liberties and civil rights, increased redistribution of incomes, and intensive hidden political strife for better governmental positions. This model might bring temporary relief for the most vulnerable social groups because market mechanisms would be simply restricted.

However such a model would inevitably and substantially impede the country's modernisation and would undermine the country's European prospects. Moreover, it would create a pretext for a full-scale Russian intervention in order to "protect the Russian world" and put the country's territorial integrity under unprecedented jeopardy.

*Scenario 3: Reforms.* This model appears to be the *single viable political vector of civilised pro-European development*. It would imply a political course targeted at considerable intensification of the reform process through the release of the social potential contained in the process of *decentralisation* and refocusing on *self-organisation within smaller regional communities*. It would allow to get rid of the country's legacy of excessive centralisation, that permanently gives rise to corruption, misuses of public funds, protects monopolism and suppresses the sources of innovation. Simultaneously, it would provide a legally more defined public room for local initiative and innovation and would enable more active and diversified voluntary interaction based on constitutional principles that are akin to the principles existing in the EU. Only in more compact, decentralised communities can Ukraine achieve the needed Europeanization based on the existence of free and socially responsible practices of its citizens. This seems to be the principal lesson in Ukrain from the period since February 2014.

## Conclusions

In the period that elapsed since February 2014, Ukraine failed to use "*the time window*" when institutional transformations, both formal and informal, could proceed most quickly and successfully. Nevertheless, the window of opportunity has not been closed yet. The ongoing military conflict substantially aggravates the crisis arising from multiple imbalances and disparities compiled within the country and in its external relations. However, despite further developments in the military sphere, Ukraine has to bring its policy of systemic transformations at a qualitatively new level, in order to safeguard its modernisation and its prospects of a globally competitive nation as well as to strengthen its potential to resist external pressure and aggression.

The slow pace of internal institutional reforms obscures the prospects of Ukraine's integration into EU structures. These prospects have been formally substantially reinforced



due to the signing of the Association Agreement with the EU. Elimination of the institutional deficiencies depends largely on the processes of decentralisation and local self-organisation, higher innovation based on strategically orientated government policies.

Political instability validates different political options and scenarios of future development, including attempts of restoration of the previous order, radicalisation on a nationalistic basis, and reformation based on consistent introduction of European principles of governance. Only the latter offers Ukraine the genuine perspective to implement successfully its highest national aspirations.

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## IS UKRAINE ON THE RIGHT TRACK OF ECONOMIC REFORMS?

### **Introduction**

The military conflict in Donbas, the erosion of incomes on account of the galloping inflation-depreciation spiral and the unrelenting collapse of trade and investment all contribute to a deep recession of Ukraine's economy for the second year running. Even under the assumption that the current ceasefire holds, an economic recovery can hardly be expected before 2017. Dismal recovery prospects, an ever-weakening currency and massive fiscal deficits have translated into insolvency of the government. Negotiations over restructuring of privately held sovereign external debt have been launched and are to be seen as part of the newly approved IMF 'rescue' package.

Many of the roots of the current economic crisis in Ukraine are deep and go back many years. Among them are government's inability to modernize and restructure the country's largely outdated and energy-wasteful industrial capacities, failure to create conducive investment climate, flawed exchange rate policy, and – most importantly – the dangerous geopolitical competition between Russia and the West over Ukraine, which has effectively contributed to the current military conflict. However, many of the economic policies pursued by the new Ukrainian government – and very much inspired by the IMF – arguably help little to solve the old problems and are likely to create the new ones. After providing an overview of Ukraine's current economic developments, this paper takes a critical view of a number of policies, such as the flexible exchange rate regime and 'shock therapy' in the area of public finances, and concludes with several policy recommendations.

### **Real economy: deepening recession**

In 2014, Ukraine's GDP contracted by 6.8% (Table 1), with economic dynamics progressively worsening from quarter to quarter. In the first quarter of 2014, the GDP decline was at 1.2% (year-on-year) still rather modest; however, it accelerated to 4.5% in the second quarter, 5.4% in the third quarter and a dramatic 14.8% in the fourth quarter. Starting from the second quarter, these figures do not cover Crimea and Sevastopol, and the figure for the fourth quarter also does not cover the eastern areas of Donbas which are controlled by the separatist rebels. Including the latter would certainly show an even deeper recession, since the war has destroyed a large part of the local production and transport capacities (more on that see below). Coal mining and the metals industry – both heavily concentrated in war-torn areas – were hit particularly hard: by 31% and

15%, respectively (in Ukraine as a whole), while machine-building, whose main export market is Russia, also reported a strong 21% decline. Apart from the weakening growth dynamics in Russia and the falling rouble, machine-building also suffered from the disruption of existing links in military-related production cooperation because of the export bans imposed by both countries, as well as Russia's import-substitution efforts. All in all, merchandise exports to Russia, which used to account for a quarter of Ukraine's exports in previous years, plummeted by a dramatic 35% last year (in US dollar terms).

**Table 1**  
**Ukraine: Selected economic indicators**

	2010	2011	2012	2013	2014	1)	2015	2016	2017
								Forecast	
Population, th pers., average	45,871	45,706	45,593	45,490	43,001		42,950	42,920	42,900
Gross domestic product, UAH bn, nom. <sup>2)</sup>	1,121	1,349	1,459	1,505	1,567		2,100	2,400	2,590
annual change in % (real) <sup>2)</sup>	4.1	5.4	0.2	0.0	-6.8		-5.0	0.0	1.8
GDP/capita (EUR at exchange rate)	2,300	2,700	3,100	3,100	2,300		.	.	.
GDP/capita (EUR at PPP)	5,600	6,500	6,700	6,700	6,500		.	.	.
Consumption of households, UAH bn, nom. <sup>2)</sup>	718	906	1,002	1,100	1,108		.	.	.
annual change in % (real) <sup>2)</sup>	7.0	15.7	8.4	7.7	-9.6		-4.5	-0.5	2.0
Gross fixed capital form., UAH bn, nom. <sup>2)</sup>	202	248	283	273	219		.	.	.
annual change in % (real) <sup>2)</sup>	3.4	6.5	3.3	-6.5	-23.0		-10.0	-5.0	5.0
Gross industrial production <sup>3)</sup>									
annual change in % (real)	11.2	8.0	-0.5	-4.3	-10.1		-6.0	0.0	3.0
Gross agricultural production									
annual change in % (real)	-1.5	19.9	-4.5	13.7	2.8		.	.	.
Construction output <sup>4)</sup>									
annual change in % (real)	-5.4	18.6	-8.3	-14.5	-20.4		.	.	.
Employed persons, LFS, th, average	20,266	20,324	20,354	20,404	18,073		17,800	17,600	17,600
annual change in %	0.4	0.3	0.1	0.2	-6.4		-1.5	-1.1	0.0
Unemployed persons, LFS, th, average	1,786	1,733	1,657	1,577	1,848		2,200	2,400	2,400
Unemployment rate, LFS, in %, average	8.1	7.9	7.5	7.2	9.3		11.0	12.0	12.0
Reg. unemployment rate, in %, end of period <sup>5)</sup>	2.0	1.8	1.8	1.8	1.7		.	.	.
Average monthly gross wages, UAH <sup>6)</sup>	2,239	2,633	3,026	3,265	3,480		.	.	.
annual change in % (real, gross)	9.7	8.9	14.3	8.2	-5.4		.	.	.
annual change in % (real, net)	10.2	8.7	14.4	8.2	-6.5		.	.	.
Consumer prices, % p.a.	9.4	8.0	0.6	-0.3	12.1		41.0	14.5	6.0
Producer prices in industry, % p.a. <sup>7)</sup>	20.9	19.0	3.7	-0.1	17.1		35.0	10.0	5.0
General governm.budget, nat.def., % of GDP									
Revenues	28.1	29.5	30.5	29.4	29.1		.	.	.
Expenditures	33.8	31.2	34.0	33.6	33.7		.	.	.
Deficit (-) / surplus (+) <sup>8)</sup>	-5.8	-1.7	-3.5	-4.2	-4.6		-5.5	-5.0	-5.0
Public debt, nat.def., % of GDP	38.6	35.1	35.3	38.8	70.2		115.0	125.0	121.0
Central bank policy rate, % p.a., end of period <sup>9)</sup>	7.75	7.75	7.50	6.50	14.00		.	.	.
Current account, EUR mn <sup>10)</sup>	-2,272	-7,351	-11,153	-12,441	-4,033		-1,500	-1,000	-1,000
Current account, % of GDP	-2.1	-6.0	-7.9	-8.8	-4.0		-2.4	-1.4	-1.4
Exports of goods, BOP, EUR mn <sup>10)</sup>	35,636	44,812	50,127	44,518	38,235		36,300	37,000	37,700
annual change in %	33.9	25.7	11.9	-11.2	-14.1		-5.0	2.0	2.0

	2010	2011	2012	2013	2014	<sup>1)</sup>	2015	2016	2017
							Forecast		
Imports of goods, BOP, EUR mn <sup>10)</sup>	42,866	57,764	67,124	61,185	44,017		39,600	39,600	40,400
annual change in %	40.8	34.8	16.2	-8.8	-28.1		-10.0	0.0	2.0
Exports of services, BOP, EUR mn <sup>10)</sup>	13,808	15,278	17,186	17,032	11,179		10,100	10,100	10,600
annual change in %	28.9	10.6	12.5	-0.9	-34.4		-10.0	0.0	5.0
Imports of services, BOP, EUR mn <sup>10)</sup>	9,577	9,613	11,351	12,141	9,437		8,500	8,500	8,900
annual change in %	15.6	0.4	18.1	7.0	-22.3		-10.0	0.0	5.0
FDI inflow (liabilities), EUR mn <sup>10)</sup>	4,860	5,177	6,360	3,396	641		300	1,000	1,500
FDI outflow (assets), EUR mn <sup>10)</sup>	521	138	762	324	414		300	300	500
Gross reserves of NB excl. gold, EUR mn	25,096	23,593	17,186	13,592	5,429		.	.	.
Gross external debt, EUR mn <sup>10)</sup>	88,363	97,940	102,120	102,852	103,556		.	.	.
Gross external debt, % of GDP	83.1	80.5	71.9	72.5	103.9		.	.	.
Average exchange rate UAH/EUR	10.533	11.092	10.271	10.612	15.716		33.0	34.0	35.0
Purchasing power parity UAH/EUR <sup>11)</sup>	4.328	4.561	4.751	4.922	5.617		.	.	.

Note: From 2014 data and forecasts excluding Crimea and Sevastopol and, for GDP and its components, parts of Donbas.  
1) Preliminary and wiiw estimates. – 2) According to SNA08. – 3) From 2011 according to NACE Rev. 2 including E (water supply, sewerage, waste management, remediation). – 4) From 2011 according to NACE Rev. 2. – 5) In % of working-age population. – 6) Enterprises with 10 and more employees. – 7) Domestic output prices. From 2013 according to NACE Rev. 2. – 8) Without transfers to Naftohaz and costs of bank recapitalisation. – 9) Discount rate of NB. – 10) Converted from USD and based on BOP 6th edition. – 11) wiiw estimates based on the 2011 International Comparison Project benchmark.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.  
<http://data.wiiw.ac.at/annual-database.html>

Exports to the European Union increased by 12% in 2014, but could not offset the decline of exports to Russia and the rest of the world; all in all, Ukrainian merchandise exports as a whole dropped by 14%, according to balance-of-payments statistics. The increase in exports to the EU was largely thanks to the unilateral abolition by the EU of most trade barriers for imports from Ukraine in spring 2014, which benefited particularly agricultural products. This measure represented a first step towards the implementation of the Deep and Comprehensive Free Trade Area (DCFTA) with the EU – part of the broader Association Agreement. However, the implementation of other parts of the DCFTA agreement – such as the gradual abolition of tariffs on imports from the EU – has been put on hold at least until the end of 2015, partly at the insistence of Russia.<sup>1</sup> This currently asymmetric arrangement is advantageous for Ukraine: it puts a brake on the influx of European goods into Ukraine, while Ukrainian exporters are able to benefit from zero import duties in the EU markets. On a negative note, the suspension of DCFTA implementation – which could potentially represent an important reform ‘anchor’ for Ukraine – means also a delay in the badly needed economic reforms and restructuring. However, the latter would only have a positive impact on economic performance if accompanied by inflows of FDI, and the latter is highly unlikely to come anyway as long as the conflict in Donbas and its future status remain unresolved, and the perceived risks of investing into Ukraine remain high.

<sup>1</sup> It also meant that Russia did not formally revoke its free trade regime with Ukraine, although a number of trade barriers for Ukrainian goods were erected on an *ad hoc* basis.

Indeed, the military conflict in Donbas has obviously had a detrimental effect on the already poor investment climate: fixed investments plunged by 23% and FDI inflows were negligibly low last year. Strong capital flight has also been a main reason behind the free fall of the hryvnia. Currency depreciation and energy tariff hikes fuelled consumer price inflation, which by February 2015 soared to 34.5% on an annual basis and eroded the purchasing power of households: on average, net wages dropped by 6.5% in real terms last year. At the same time, credits to households fell by 16% (after adjusting for the valuation effect of forex-denominated loans) amidst strong deposit outflows and the overall gloomy economic prospects. All this weighed heavily on private consumption, which fell by nearly 10% last year. On a positive note, the combined effect of currency depreciation and falling domestic demand contributed to a sharp drop in imports of goods and services by 27% in US dollar terms – much more than that of exports (-20%), resulting in vastly improved trade and current accounts and a strongly positive contribution of real net exports to GDP growth.

Economic prospects remain crucially dependent on a lasting peace settlement of the Donbas conflict. For 2015, another recession – in the tune of at least 5% – will not be avoided, with substantial risks on the downside, and recovery can hardly be expected before 2017. Among other things, the ongoing war deters the inflow of foreign investments, which are badly needed to modernise the economy and finance the costly implementation of EU technical standards and numerous other regulations ('acquis') within the framework of the newly signed – but temporarily suspended until January 2016 – DCFTA agreement with the EU. It is also unlikely that Ukraine's export sector will be able to take advantage of the highly competitive exchange rate, given that part of the production and transportation capacities are physically destroyed and trade with Russia remains severely curtailed, while an increase in manufacturing exports to the EU is conditional on improved competitiveness, including the costly implementation of EU standards as envisaged in the DCFTA agreement – both possible only in the medium and longer run. Important exceptions to this may be agriculture and parts of the food processing industry, which are largely located outside the conflict zone and have been able to benefit to some extent from the newly granted market access for their products by the EU.

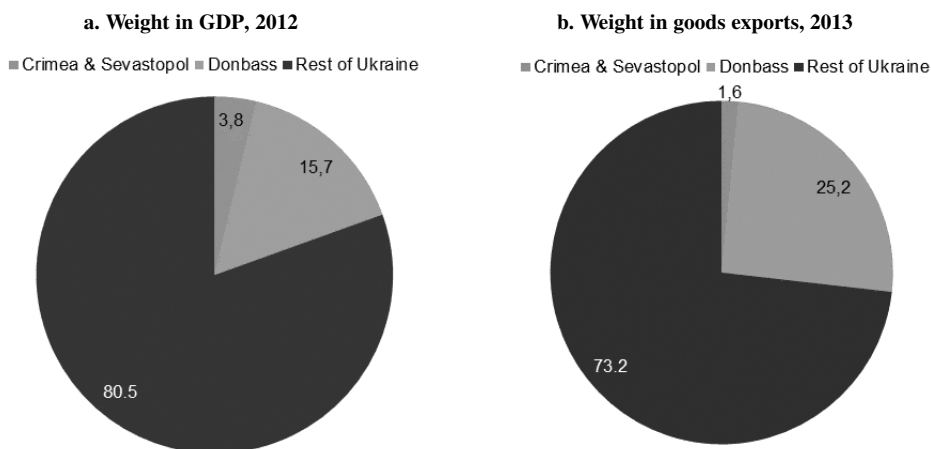
### **Economic losses due to war in Donbas and secession of Crimea**

The Donetsk and Luhansk eastern provinces – commonly referred to as Donbas – are located in the easternmost part of Ukraine and have a combined territory of 53 thousand square kilometres and a pre-conflict population of 6.5 million people. Home to coal mining and metallurgy, Donbas has traditionally been Ukraine's industrial heartland, accounting for 16% of GDP and a quarter of exports (Figure 1). The Donetsk region was statistically the second richest in Ukraine in per capita GDP terms behind the capital city Kyiv (Figure 2). Despite its relatively high development level (by Ukrainian standards), Donbas was

however a net recipient of fiscal transfers from Kyiv, largely thanks to coal mining subsidies.<sup>2</sup>

In the first months of the conflict, it was primarily local small and medium-sized businesses which suffered the most. However, as the civil war was gaining momentum, the big industrial enterprises which form the backbone of the Donbas economy, such as those in the metals and chemicals sectors, became increasingly affected as well. In July 2014, statistics reported for the first time huge drops in industrial production in both provinces, which only deepened during the subsequent months. According to official (certainly incomplete) statistics, in 2014 industrial output plunged by over 30% in Donetsk and more than 40% in Luhansk, largely accounting for the 11% decline in Ukraine as a whole. Apart from fighting, the most important factor behind the halt in production has been damages to infrastructure, notably railway connections and electricity supply. For instance, 70% of coal mines have reportedly ceased operation because of electricity shortages and related flooding, although the lack of crucial inputs such as explosives played a role as well. The split of large parts of Donbas from the rest of Ukraine has also resulted in a disruption of production links, particularly in the important metals industry. Steel mills located in the rest of Ukraine have found themselves short of coal supplies, which used to come from mines in Donbas, and have been forced to switch to coal imported from elsewhere, notably South Africa. Conversely, steel mills in the rebel areas are reportedly lacking iron ore, which largely comes from the central regions of Ukraine.

**Figure 1 / Weight of Crimea, Sevastopol and Donbas in Ukraine's GDP and exports**



*Note:* Donbas encompasses the Donetsk and Luhansk regions.  
Source: wiiw based on national statistics.

<sup>2</sup> Anecdotal evidence suggests however that these subsidies were allocated not for the purpose of covering the losses of coal mines, many of which were in fact profitable, but rather represented hidden budget support to oligarchs who controlled a large part of mines and were close to former president Viktor Yanukovich.

According to the most recent USAID estimate which was announced by Prime Minister Yatsenyuk on 27 February 2015, the war-related damages in Donbas amount to some USD 1.5 billion.<sup>3</sup> However, this figure only covers territories which are now under Kyiv's control. Including areas controlled by the separatists would certainly yield a much higher estimate. A more realistic estimate was provided in autumn 2014 by the head of Ukraine's Union of Industrialists and Entrepreneurs Anatoliy Kinakh: USD 7-8 billion. However, even this figure underestimates the true extent of the damage incurred, because the resumption of fighting which took place in January 2015 entailed further losses. Taking into account the most recent intense fights (notably in Debaltsevo and the Donetsk airport), the cumulated war-related damage to infrastructure in Donbas has probably reached by now some USD 10 billion, corresponding to about 8% of Ukraine's GDP in 2014. Officially, reported damages include some 10 thousand apartment buildings, 1,080 objects of energy infrastructure, 1,514 railway infrastructure facilities, 1,561 km of public roads, 33 bridges, and 28 air traffic control facilities.<sup>4</sup> All in all, according to official estimates, the military conflict in Donbas reduced Ukraine's GDP by 2.5 pp last year, including 1.9 pp due to the decline in the Donetsk and Luhansk regions and another 0.6 pp due to contagion effects.<sup>5</sup>

The destruction of production and transportation capacities in the region means that in the short run, up to 1.8 million people in Donbas may stay unemployed, according to official estimates. In the longer run, however, the problem may well be the opposite: labour shortages due to the high number of refugees, many of whom may not come back. By the latest count, almost 2 million people, or nearly one-third of the Donbas population, have left the region since the outbreak of the conflict, including nearly one million registered as 'internally displaced' in other parts of Ukraine (according to Ukraine's Ministry of Social Policy) and up to 900 thousand who fled to other countries, mostly to Russia.<sup>6</sup>

<sup>3</sup> <http://forbes.ua/news/1389580-ubytki-ot-vojni-sostavlyayut-15-mlrd>.

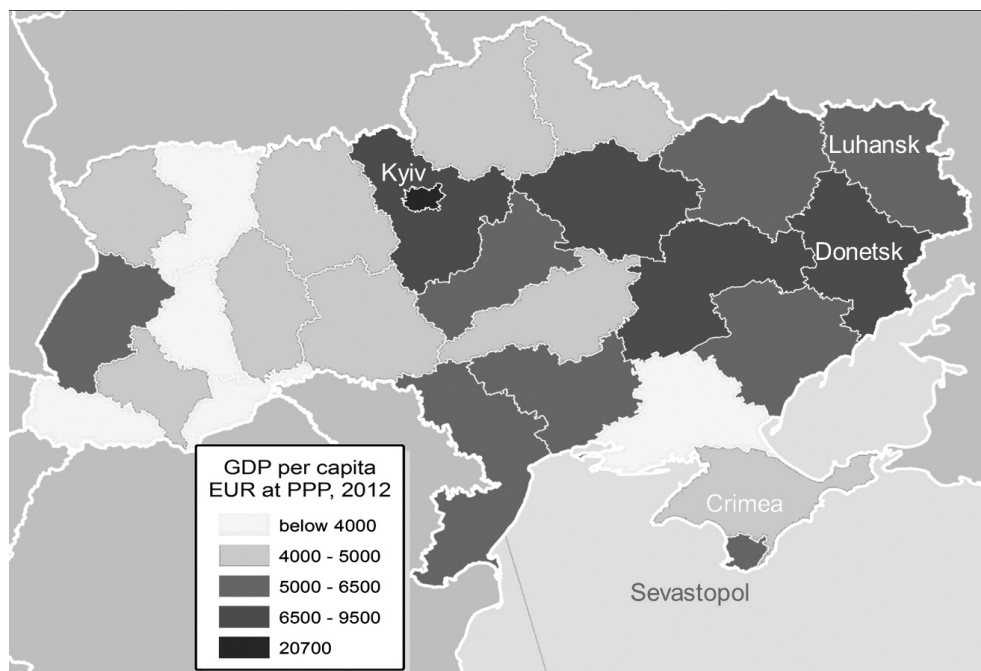
<sup>4</sup> Lubkivsky (2015). It is not clear however to what degree the Ukrainian authorities are able to assess the extent of the damage on the territories which are not under their control.

<sup>5</sup> Rashkovan (2015).

<sup>6</sup> Estimates with respect to the number of Donbas refugees who fled to other countries differ by a wide margin.



Figure 2 / Gross regional product per capita in 2012, in EUR at PPP



*Note:* Purchasing power parity (PPP) is wiiw estimate based on the 2011 International Comparison Project benchmark, and is assumed to be the same across regions.

*Source:* Own calculations based on data from the State Statistics Service of Ukraine.

By way of contrast, the annexation of Crimea and Sevastopol (a port city which constituted a separate administrative entity) by Russia entailed much smaller economic losses for Ukraine. The two provinces have a combined population of 2.4 million, or 5% of Ukraine's total, while their economic weight was even lower: 4% of GDP and only 2% of exports of goods and services. Thus, Crimea and Sevastopol were underperforming regions even by Ukrainian (rather low) standards: their GDP per capita was lower than the national average, and both provinces were chronically net recipients of fiscal transfers from Kyiv.<sup>7</sup> For both regions, the takeover by Russia, which is on average three times richer than Ukraine, had among other things a clear economic attraction, and made them eligible for transfers of much larger magnitude than those received from Kyiv – not to speak of the potential for increased investments into infrastructure, including the planned construction of a bridge from mainland Russia. In turn, for Ukraine the takeover of both regions by Russia meant that the government no longer needs to subsidise them, which has been a modest relief to the central government budget.

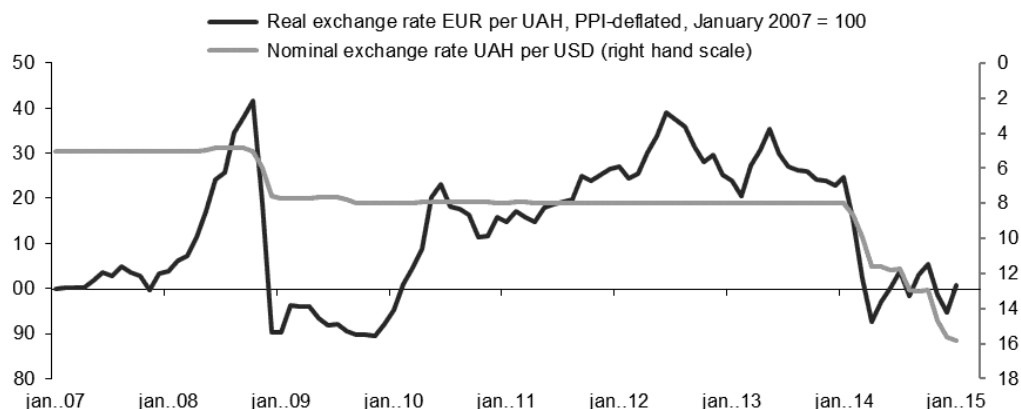
<sup>7</sup> The low official GDP figures may however also reflect the extent of the 'shadow economy' which is likely to be pronounced given the region's reliance on tourism. The estimates of the extent of the shadow economy for Ukraine as a whole generally range between 40% and 50% of GDP.

It is however clear that, irrespective of the above-mentioned minor positive effects for the budget, the departure of Crimea and Sevastopol has diminished Ukraine's economic potential, although the precise magnitude of related losses is difficult to quantify. Apart from the unique sub-tropical climate on the southern Black Sea Riviera and related tourist facilities, the region features some industrial assets (including a titanium plant owned by Dmytro Firtash) and port facilities, 40% of Ukraine's ships and boats exports, as well as 6% of gas and 16% of oil deposits (off-shore) – even if their recovery is rather expensive for geological reasons.

### Flexible exchange rate a big disappointment

Under the leadership of former president Yanukovych, Ukraine used to have a fixed exchange rate regime, with the hryvnia pegged to the US dollar at a fixed rate of 8 UAH/USD. Because of the relatively higher domestic inflation, this arrangement led over time to increasing currency overvaluation (see Figure 3). In addition, the problem was magnified by the fact that Ukraine's terms of trade suffered on account of depressed world prices of steel (its main export item until recently), while the fixed exchange rate could not adjust accordingly and 'absorb' this negative terms-of-trade shock, i.e. render the economy to become more competitive. The result of this policy was mounting current account deficits, which increased from 2% of GDP in 2010 to nearly 9% in 2013 (Figure 4). Since those deficits were not fully offset by net capital inflows, the National Bank of Ukraine (NBU) was forced to sell its reserves in order to defend the exchange rate, so that their stock in relation to GDP more than halved between 2010 and 2013.

Figure 3 / Nominal and real exchange rates, 2007-2015

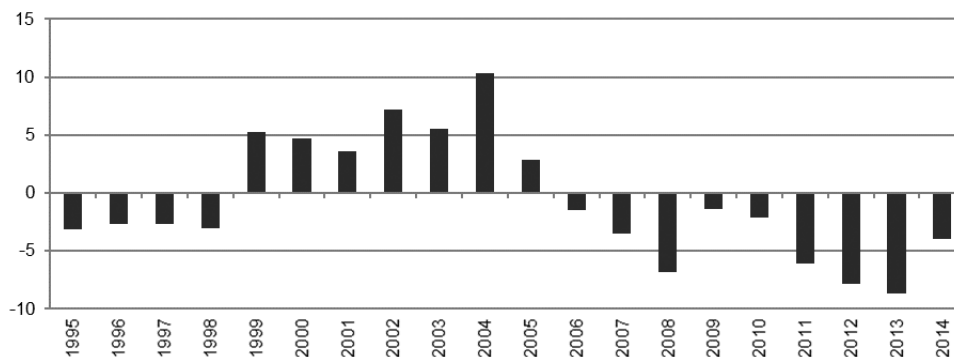


Note: Values more than 100 indicate real appreciation against January 2007.

Source: wiiw Monthly Database incorporating national statistics.

The sharp increase in political and economic uncertainty following the ‘Maidan revolution’ led to unprecedented capital outflows from Ukraine: in 2014, they totalled USD 8 billion, USD 2.6 billion of which represented purchases of foreign currency by b. In this new macroeconomic environment, the previous fixed peg could no longer be defended, and the NBU switched to a flexible exchange rate regime – partly also under pressure from the IMF, and resulting in a subsequent free fall of the hryvnia. During the year following the Maidan revolution, the hryvnia lost around three-quarters of its value, falling from 8 to 32 UAH/USD.

Figure 4 / Current account in % of GDP, 1995-2014



Source: wiiw Annual Database incorporating national statistics.

For various reasons, the NBU has been however trying to limit the scope of currency depreciation. First, depreciation is fuelling inflation via the increased price of imported goods. Second, it is jeopardising the stability of the banking system because of the latter’s high dollarisation level. Despite the near-ban on lending in foreign currency imposed during the crisis of 2008-2009, by the end of 2013 foreign currency loans still accounted for 32% of total loans extended to households and 35% of those to businesses (loans denominated mostly in US dollars; other currencies play only a marginal role). The steep hryvnia depreciation has increased the debt burden on those borrowers and, because of the rising non-performing loans, has become a problem for banks as well.<sup>8</sup> Finally, depreciation has also affected the dynamics of public debt, more than half of which is denominated in foreign currency. During 2014, public debt stock soared by over 30 percentage points (pp) of GDP (from 39% to 70%), of which more than 20 pp was solely on account of currency depreciation, according to wiiw calculations.

In order to put a brake on currency depreciation, the NBU has resorted to a range of measures, including a further tightening of monetary policy<sup>9</sup> and a number of admi-

<sup>8</sup> Because of the valuation effect of currency depreciation, which inflated the value of dollar credits in national currency terms, the share of foreign currency loans jumped dramatically in the course of 2014: to 43% for households and 48% for businesses.

<sup>9</sup> The NBU key policy rate (discount rate) was hiked five times over the past year, bringing it to 30% p.a.

nistrative restrictions of the foreign exchange market, including a 100% surrender requirement for the incoming foreign exchange (later reduced to 75%) and several steps aimed at curbing the foreign exchange demand. However, in reality the choice of instruments at NBU's disposal has been very limited: official reserves are already at a critically low level of USD 5.6 billion (covering just one month of imports), interest rate hikes hardly provide an incentive to invest into a war-torn country, while the imposed administrative measures have only resulted in growing currency shortages and the emergence of a vast 'shadow' market for foreign exchange.<sup>10</sup> In addition, the foreign exchange market continues to be rather 'thin', with only a few currency speculators able to generate substantial exchange rate fluctuations – a task made nowadays particularly easy because of the military conflict and the related 'bearish' market sentiments. The formally adopted 'inflation targeting' which in theory accompanies a flexible exchange rate regime remains an empty slogan, with inflation rates meanwhile exceeding 30% p.a. and the ineffectiveness of traditional monetary policy instruments such as interest rates.

**BOX 1 / ESTIMATING UKRAINE'S EXTERNAL FINANCING REQUIREMENT FOR 2015**

Projected current account deficit: USD 1.7 billion  
 Projected FDI inflow: 0  
 External debt service of government: USD 7.7 billion  
 External debt service of private sector<sup>11</sup>: USD 8.1 billion  
 Projected purchases of foreign currency by households: USD 1 billion  
 Required replenishment of NBU's foreign reserves<sup>12</sup>: USD 10.4 billion

*Minus:* Expected inflows from the IMF under the newly approved EFF<sup>13</sup>: – USD 10 billion  
 Expected inflows from other multilateral and bilateral lenders under EFF: – USD 3.5 billion

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**Total: ~ USD 15 billion**

Source: NBU, IMF (2015), SP Advisors (2015), own estimates.

All in all, Ukraine continues to be critically dependent on foreign emergency assistance, the bulk of it coming from the IMF. Last year, Ukraine received USD 4.6 billion as part of the USD 17 billion Stand-by Arrangement (SBA) agreed with the IMF in April 2014, as well as a total of another USD 4.5 billion in other multilateral and bilateral loans and credit guarantees, such as from the World Bank, the EBRD, the EU, the

<sup>10</sup> On 5 February 2015, the exchange rates were unified, resulting in another massive depreciation of the hryvnia. However, at the beginning of March, extensive administrative controls were re-imposed once again, bringing about a (likely temporary) recovery of the *official* exchange rate to levels around 23 UAH/USD by the time of finalising this report (end-March 2015).

<sup>11</sup> Includes both the corporate and the banking sector, assuming an 85% rollover ratio of existing credit liabilities.

<sup>12</sup> Amount required for replenishing NBU's foreign exchange reserves from the current level (USD 5.6 billion as of end-February 2015) to a level covering three months of imports (USD 16 billion).

<sup>13</sup> Ukraine already received USD 5 billion under the EFF programme in March 2015.

United States and Japan.<sup>14</sup> Upon its inception, the IMF programme implicitly assumed that the country's balance-of-payments (and fiscal) problems were those of liquidity rather than solvency: economic recovery and currency stabilisation were expected to enable external debt repayment in the longer run.<sup>15</sup> This assumption – arguably justified at that time – looks now increasingly unrealistic, as economic recovery is not in sight, and the hryvnia is likely to depreciate even more, while high defence spending continues to hamper budget consolidation. Rising concerns over public debt sustainability are also pushing upwards the yields on government Eurobonds; the latter stand on average at 7.1% p.a.<sup>16</sup> – much higher than the GDP growth rate in US dollar terms (which is negative), thus contributing towards the debt to GDP ratio rising still further and sovereign default becoming a 'self-fulfilling prophecy'.

The new IMF lending arrangement to Ukraine approved on 11 March 2015 – a four-year Extended Fund Facility (EFF) worth USD 17.5 billion, which replaced the earlier SBA package – should be seen as recognition of the solvency problems the country is facing. It is only USD 5 billion larger in volume than the funds outstanding in the framework of the SBA (USD 12.5 billion); in addition, these funds are to be disbursed over a much longer period: four years instead of one. On the other hand, the IMF package is to be supplemented with some USD 8 billion worth of net disbursements from other multilateral and bilateral lenders (especially the United States and the EU, but also from the World Bank, EBRD, and EIB), which will bring the size of the total financial package to around USD 25 billion over the next four years. Still, these funds will be almost certainly not enough to meet Ukraine's external financing requirement, which in 2015 alone is projected by wiiw at approximately USD 15 billion – see Box 1.

Therefore, the new IMF package explicitly assumes partial restructuring of *privately held* sovereign foreign debt (i.e. debt owed to the London Club of creditors), which represents around half of the total and stands at some USD 18 billion, including USD 3 billion owed to Russia.<sup>17</sup> Overall, such restructuring – diplomatically referred to by the IMF as 'debt operations' – should save Ukraine USD 15 billion in debt payments over the entire period 2015-2018; this year alone, USD 5.2 billion is to be saved this way (IMF, 2015). Negotiations over debt restructuring have already started, and will likely lead to a reduction in interest payments and principal, as well as maturity extension up to 10-15 years on the remaining debt (BNP Paribas, 2015). According to some estimates, about 40% of the debt may be written off as a result, with the US-based fund Franklin Templeton – the largest single private holder of Ukraine's sovereign debt worth

<sup>14</sup> The net inflows of IMF funds during this period amounted however to less than USD 1 billion, since the bulk of the newly arrived funds were used to repay old IMF credits.

<sup>15</sup> Several authors, such as Schadler (2014) and Lachman (2015), argue that the IMF projections underlying its decision to extend an SBA to Ukraine were heavily skewed towards optimism from the very beginning.

<sup>16</sup> <http://forbes.ua/news/1391410-mvf-poka-ne-reshil-yavlyaetsya-li-dolg-ukrainy-pered-rf-oficialnym>

<sup>17</sup> This debt owed to Russia's National Welfare Fund is held in the form of Eurobonds, giving rise to controversies whether it should be treated as official or rather as private debt.

some USD 7 billion – poised to lose the most.<sup>18</sup> However, given Ukraine’s external financial requirements (see Box 1), even this impressive amount of debt restructuring which is envisaged by the IMF is probably an under-estimate.

### Fiscal policy: defence spending offsets IMF-imposed austerity

In 2014, both revenues and expenditures of the general government were nearly stagnant (+3% nominally, Table 2), which implied a 10% drop in real terms. This appears to be well in line with the stated government strategy (partly inspired by the IMF) to reduce the role of the state in the economy. However, the almost identical dynamics of revenues and expenditures last year suggests that the declared target of budget consolidation has not been met. Although the conditionality attached to the IMF loans officially requires budget austerity, in practice the latter has been offset by the ballooning military spending which was (seemingly) tolerated by the IMF. As a result, the government deficit as a percentage of GDP even increased somewhat: from 4.2% of GDP in 2013 to 4.6% of GDP last year – see Table 1.<sup>19</sup>

Table 2 / General government budget, 2013-2014

	UAH billion		2014, as % of 2013
	2013	2014	
<b>Revenues</b>	<b>442.8</b>	<b>455.9</b>	<b>103.0</b>
Income tax	72.2	75.2	104.2
Corporate profit tax	55.0	40.2	73.1
Value-added tax	181.7	189.2	104.1
Value-added tax refunded	-53.4	-50.2	94.0
Excise tax on domestically-produced goods	27.7	28.2	101.9
Excise tax on imported goods	8.9	16.9	188.4
Royalties on mineral resources	14.2	19.6	137.9
Royalties on land	12.8	12.1	94.4
Import customs duties	13.3	12.4	93.4
NBU profits	28.3	22.8	80.6
Own revenues of budgetary institutions	37.9	31.5	83.2
<b>Expenditures</b>	<b>505.8</b>	<b>523.0</b>	<b>103.4</b>
State administration (excl. debt service)	28.5	27.4	96.1
Debt service	33.2	49.4	149.0
Defence	14.8	27.4	184.4
Public order, security and judiciary	39.4	44.9	113.8
Economic activity	50.8	43.6	86.0
Environmental protection	5.6	3.5	62.1
Housing and communal services	7.7	17.8	231.1
Health care	61.6	57.0	92.7
Culture, arts and sports	13.7	13.9	101.4
Education	105.5	100.1	94.9
Social security and welfare	145.1	138.0	95.1

<sup>18</sup> *Financial Times*, ‘Contrarian US investor with \$7 bn of debt stands to lose most if Kiev imposes haircuts’, 12 February 2015, p. 3. Other large holders of Ukrainian debt reportedly include i.a. BlackRock, Allianz, and Fidelity.

<sup>19</sup> These figures do not include the substantial quasi-fiscal deficits – more on that see below.

	UAH billion		2014, as % of 2013
	2013	2014	
<b>Credits</b>	<b>0.5</b>	<b>5.0</b>	-
Credits taken	6.1	6.8	-
Credits repaid	-5.6	-1.9	-
<b>Budget balance ('+' deficit, '-' surplus), incl.</b>	<b>63.6</b>	<b>72.0</b>	-
Issued bonds to compensate local budgets for the difference in tariffs	-	11.1	-
Issued bonds for the purpose of VAT refunds requested prior to January 1, 2014	-	6.9	-
<b>Budget balance ('+' deficit, '-' surplus) in comparable terms (w/o issued bonds)</b>	<b>63.6</b>	<b>54.1</b>	-

Source: Ministry of Finance.

On the revenue side, tax collection was crucially helped by a spike in inflation which offset the negative impact of the recession, as well as the hikes in regulated prices and excise taxes on alcohol and tobacco implemented as part of the austerity package. Also, property taxes and royalties on the extraction of natural resources were raised, and the (nearly) 'flat' tax regime for personal incomes made more progressive, albeit with thresholds set at rather high levels. In addition, state revenues benefited from the 1.5% 'war' payroll tax introduced from August 2014 (and prolonged for 2015).

Table 2 also reveals a marked shift in the structure of government expenditures in 2014. The two biggest expenditure items – social payments and spending on education – were cut by 5% and spending on health by 7% in nominal terms, implying a reduction by up to 20% in real terms. Among the austerity measures implemented in this vein were a 'freeze' of the minimum wage, a 10% reduction in the number of civil servants, and cuts in some of civil servants' pensions and privileges. The secession of the net budget transfer recipients Crimea and Sevastopol, as well as the suspension of pensions and other transfers to the rebel areas in Donbas implemented in autumn 2014 have contributed towards a reduction of government expenditures as well.<sup>20</sup> Allocations to the 'national economy' were reduced by 14%, with a strong emphasis on cuts in capital spending. A large part of funds saved in this way were channelled to pay interest on the public debt (+49%) and for military purposes: defence spending increased by 84% (albeit starting from a rather low basis) and amounted to some UAH 28 billion (1.8% of GDP).<sup>21</sup>

Following the latest IMF recommendations, the amended central government budget for 2015 targets a somewhat lower deficit of 4.1% of GDP. However, attaining even this (seemingly moderate) target under conditions of a severe economic recession would require a sizeable consolidation effort of 7.4% of GDP, of which 3.3 pp is to be achieved thanks to higher budget revenues, and 4.1 pp due to expenditure cuts (in real terms). Thus, the extent of fiscal consolidation required from Ukraine by the IMF (not taking

<sup>20</sup> According to IMF (2015), the Ukrainian government saved 0.4% of GDP in this way.

<sup>21</sup> Here and thereafter, budgetary allocations to defence do not include private financing of volunteer regiments fighting on the government side.

into account the reduction in energy subsidies – see below) exceeds that in Portugal, Italy and Spain in 2011-2013 (5-7% of GDP), although it is somewhat lower than the one implemented in Greece (8-9%). Judging from these countries' experience, the IMF assumption with respect to the size of the fiscal multiplier in Ukraine is probably over-optimistic,<sup>22</sup> and the recessionary impact of government austerity on the real economy may turn out to be much higher than anticipated, potentially resulting in GDP falling by up to 10% this year.<sup>23</sup>

The growth of government revenues is projected at 32% in nominal terms – roughly in line with inflation, and notwithstanding the severe economic downturn. The government reckons that tax collection should benefit from the newly enacted comprehensive tax reform: as of January 2015, the tax system has been streamlined and the number of taxes reduced from 22 to 9, while a drastic lowering of social security contributions and a generous tax amnesty are hoped to encourage the 'de-shadowing' of the economy. In addition, government revenues should be boosted by the newly imposed temporary (until the end of 2015) 5-10% surcharge on all imports, excluding energy and pharmaceuticals, although this might be in violation of WTO rules.<sup>24</sup>

On the expenditure side, the 2015 budget envisages further austerity measures, such as additional cuts in the number of public employees (especially in law enforcement agencies, but also in other ministries and at the NBU) and a 'freeze' of the minimum wage until December 2015, implying a further erosion of real incomes by high inflation. Also, pensions for *working* pensioners which exceed UAH 1,423 (some USD 50) per month will be cut by 15% as of April 2015 and until the end of this year. However, as last year, the austerity impact of these measures will be offset by a near-doubling (in nominal terms) of military spending: budget allocations for security and defence amount to UAH 90 billion, or 5% of GDP. According to the government, the 'anti-terrorist operation' in Donbas costs USD 5-10 million per day. Extrapolated for the whole year, this would sum up to some USD 2-4 billion, or 2-4% of GDP (obviously, the costs can be easily higher if the fighting escalates further). While the effectiveness of the Ukrainian army on the battlefield is far from being impressive, high military spending – mirrored in the statistics by the growth of public consumption – provides at least some growth stimulus in an otherwise strongly recessionary environment.

Finally, and probably most importantly, the officially reported budget figures and targets discussed above do not include important quasi-fiscal expenditure items, such as

<sup>22</sup> In a recently published working paper (Mitra and Poghosyan, 2015), the IMF has found that fiscal multipliers in Ukraine are relatively low and below one.

<sup>23</sup> This estimate has been provided by Gorodnichenko (2015) who applied to the case of Ukraine the findings of Blanchard and Leigh (2013) that the IMF has systematically under-estimated the contractionary impact of fiscal consolidation by 0.7 pp for every 1 pp of forecasted drop in GDP.

<sup>24</sup> The WTO will consider the case in April 2015. The official justification for the import surcharge is 'to contain balance-of-payments pressures' in line with Article XII of GATT agreement (IMF 2015).



subsidies to the state-owned energy company Naftohaz (resulting from low domestic gas tariffs), transfers to the Pension Fund, and costs of bank recapitalisation. According to IMF (2015), the Naftohaz deficit alone accounted for 5.7% of GDP last year, as strong currency depreciation inflated the gas import bill in hryvnia terms, which was only partially offset by the enacted domestic tariff hikes.<sup>25</sup> This year, the import gas price for Ukraine should decline (at least in US dollar terms) thanks to the recent drop in the oil price, to which it is contractually linked. Nevertheless, in line with the latest budget amendments and under pressure from the IMF, retail gas tariffs were hiked on average by 284% and those for heating by 66% as of 1 April 2015. These moves should reduce the deficit of Naftohaz to 3.1% of GDP and bring down the consolidated (i.e. including all quasi-fiscal entities) government deficit to 8.8% this year (from 13.5% in 2014).<sup>26</sup> However, they will also contribute an estimated 9 pp to consumer price inflation this year<sup>27</sup> and thus further erode the purchasing power of the majority of the country's households. In the longer run (until April 2017), the IMF requires that gas tariffs be hiked to 'cost-recovery levels', i.e. raised approximately five times from their present level.

### Policy recommendations

As indicated above, the war-related damages in Donbas already amount to at least USD 10 billion (8% of GDP), and may end up being much higher. It goes without saying that, given the extent of the damage, restoration of normal economic activities in the affected territories will require massive public investment. Since the cash-stripped Ukrainian government will hardly be able to come up with adequate funds on its own, the EU could potentially play a crucial role here – ideally by designing a sort of 'Marshall Plan' for Ukraine; similar plans have been advocated recently e.g. by George Soros<sup>28</sup> and Dmytro Firtash.<sup>29</sup> At the same time, it is important to bear in mind that, given pervasive corruption in Ukraine, a substantial share of EU funds is likely to be embezzled or stolen.<sup>30</sup> Even large-scale financial assistance from abroad will not bring the expected benefits to Ukraine's economy unless it is accompanied by a wide range of – above all institutional – reforms.

The current flexible exchange rate regime – which is a key IMF conditionality, coupled with inflation targeting – is clearly inappropriate for Ukraine under the conditions of *de facto* war, elevated political and economic uncertainties, and the high

<sup>25</sup> Gas tariffs for households were hiked by 60% and those for district heating companies by 40% as of 1 May and 1 July 2014, respectively.

<sup>26</sup> <http://forbes.ua/nation/1389731-ne-hotelos-no-kushat-nado>

<sup>27</sup> Rashkovan (2015).

<sup>28</sup> Reuters, 'Soros urges giving Ukraine \$50 billion of aid to foil Russia', 8 January 2015, <http://www.reuters.com/article/2015/01/08/ukraine-crisis-soros-idUSL6N0UN13720150108>

<sup>29</sup> Telepolis, 'Deutsche Politiker im Verbund mit ukrainischen Oligarchen', 4 March 2015, <http://www.heise.de/tp/artikel/44/44303/1.html>

<sup>30</sup> The same caveat applies also to other types of potential EU financial assistance outlined below.

degree of dollarisation of the economy. Therefore, macroeconomic stabilisation will require a more stable exchange rate regime which could serve as a ‘nominal anchor’ of inflationary expectations and put an end to the current depreciation-inflation spiral. At the same time, the adoption of a fixed peg regime similar to the one which was in place under former president Yanukovich is unrealistic and bears the dangers of overvaluation which may materialise rather soon with the levels of inflation currently observed. An optimal compromise could be a fixed but adjustable exchange rate regime, or alternatively a ‘crawling peg’; these types of exchange rate arrangements were widely used to achieve macroeconomic stabilisation in a number of CESEE countries during the 1990s and generally proved their effectiveness. However, in order to make a new exchange rate regime credible, the National Bank of Ukraine would need a substantially higher volume of foreign exchange reserves: the current level of USD 5.6 billion covering a mere one month of imports is clearly insufficient. Even the customarily used benchmark of three months of imports as the absolutely crucial minimum of the reserves level (which would correspond to some USD 15-16 billion) may not be enough to ensure credibility under the current circumstances. Realistically, the NBU would probably require additional funds to the tune of USD 15-20 billion to this end. This is far above the new IMF package which is supposed to cover a wide range of Ukraine’s needs apart from forex reserve replenishment, including foreign debt repayment and budgetary support. Increased availability of forex reserves could also allow the NBU to lower interest rates and thus mitigate somewhat the economic recession.

With gas and heating tariffs for households being artificially low and the energy intensity of the economy among the world’s highest, the necessity of tariff hikes which would encourage energy-saving behaviour of consumers is fairly obvious. Therefore, in principle the government deserves praise for implementing this highly unpopular step.<sup>31</sup> However, the wisdom of front-loaded tariff hikes is questionable unless they are accompanied by parallel efforts aimed at promoting energy-saving investments. Such efforts could complement, for instance, the recent EBRD programmes in Ukraine which have gained major traction in energy efficiency results, and draw on the past successful experience in other East European countries such as Romania.<sup>32</sup> One possible area of government involvement could be, for instance, the installation of heating metres which may be unaffordable for the vast majority of poorer households without targeted subsidies from the government: As long as households continue using old Soviet-style heating infrastructure which does not allow to regulate the temperature, any hopes for a reduction in energy consumption in response to tariff hikes may be elusive. Another possible area of government support could be the thermal insulation

<sup>31</sup> Another challenge is low energy efficiency in the industrial sector – despite the already high (cost-covering) level of energy tariffs for industry. Ukraine’s industry, especially its energy-intensive branches such as metals and chemicals, still rely to a large extent on obsolete technologies which often date back to the 1950s and are extremely energy-wasteful.

<sup>32</sup> See, for instance, EBRD (2009).

of residential buildings.<sup>33</sup> Government subsidies along these lines would be crucial in solving the long-term structural problem of excessive energy consumption, and should enjoy priority over the short-term task of fiscal consolidation (which is probably the real motivation for the implemented tariff hikes). In fact, they could be financed from the tariff hikes, leaving the overall fiscal deficit unchanged.<sup>34</sup>

More generally, the current composition of government expenditures is sub-optimal. High military spending and high costs of public debt service are ‘crowding out’ other essential budget payments while broad-based reductions in expenditures on health and education, and a freeze of the minimum wages and pensions under conditions of high inflation contribute to a progressive degradation of the welfare state and impoverishment of vast segments of the population. This means not only less investment into human capital, with the potential negative repercussions for long-term growth prospects, but also less public support for reforms. Therefore, an optimal structure of government expenditures would require more social and less defence spending, and also a smaller public debt burden. The efficiency of military expenditures is highly questionable anyway, if only because Ukraine realistically cannot win its *de facto* ‘hybrid war’ against Russia, no matter how high its military expenditures are. As for the burden of public debt, the current negotiations over debt restructuring are a welcome step in the right direction, but may potentially require debt ‘haircuts’ larger than those on the negotiating table.

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<sup>33</sup> According to some estimates, thermal insulation of a typical five-storey residential building would require some USD 100,000 in investments, which would reduce its heating consumption by half. For Ukraine as a whole, this would translate into some 40% of GDP or e.g. 2.5% of GDP per year if the programme is extended over 15 years – an amount which is to be saved thanks to tariff hikes.

<sup>34</sup> Although the government is planning to allocate UAH 12.5 billion (0.7% of GDP) in direct heating subsidies to the poor to offset the impact of tariff hikes, this will hardly contribute towards improving energy efficiency.

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ALEXANDER DULEBA

## EAST EUROPEAN CRISIS: AN ATTEMPT TO INTERPRET ITS NATURE AND IMPLICATIONS FOR THE EU AND THE EASTERN PARTNERSHIP

Many in the EU believe that what is still referred to as the ‘Ukrainian crisis’ is just an episode somewhere far away in Eastern Europe, which will cease sooner rather than later, and the EU will then once again re-establish its pragmatic and ‘business as usual’ relations with Putin’s Russia. We argue in this article that they are wrong. A number of EU leaders, including three V4 prime ministers, prefer to save domestic jobs and see the EU’s economic sanctions against Russia as baseless and crazy. In other words, they believe that what happened in Crimea last year and what is happening in the Donbas now is a local or domestic Ukrainian crisis, which does not matter much for the EU and there is no need to pay a price for it. If this line of thinking should come to shape the EU’s policy towards Ukraine and Russia in the months to come, it will cost the EU taxpayers much more than the consequences of economic sanctions against Russia. Starting with Russia’s annexation of Crimea at the end of February 2014, the Ukrainian crisis turned into a full-fledged European crisis. The EU cannot escape the crisis. It has to face it.

The aim of this article is to outline the consequences of the recent crisis in Eastern Europe for the EU as an international actor in Europe, including also the impact on the further development of the Eastern Partnership as the EU’s policy framework for its relations with six Eastern European neighbors.<sup>1</sup> In a narrow sense, this article focuses on the consequences this crisis has on the EU policy towards Georgia, Moldova and Ukraine – the only Eastern partner countries with the capacity to engage in a potential implementation of the Association Agreement with Deep and Comprehensive Free Trade Area component (AA/DCFTA) with the EU. AA/DCFTA is at the very core of what the Eastern Partnership has to offer, as its implementation implies the economic integration of a given partner country into the EU’s single market.<sup>2</sup>

<sup>1</sup> The arguments presented by the author in this article concerning the interpretation of the nature of the recent Russian-Ukrainian crisis and its implications for the EU, including the Eastern Partnership as the EU framework policy towards the six East European countries, have been discussed at the conference entitled *East European crisis: scenarios and EU response*, organized by the Research Center of the Slovak Foreign Policy Association in Bratislava on October 27, 2014, <http://www.sfpa.sk/en/podujatia/odborne-podujatia/1145> (accessed on March 27, 2015). This article also draws on the following essay by the author: Russian-Ukrainian crisis: What’s next for the Eastern Partnership. In: *International Issues & Slovak Foreign Policy Affairs*, Vol. XXIII, No.3-4, 2014, pp. 57-70.

<sup>2</sup> The European Commission has outlined the nature of a Deep and Comprehensive Free Trade Agreement in its Communications on “Strengthening the ENP” of 4 December 2006 – COM(2006)726, “A Strong ENP” of 5 December 2007 – COM(2007) 774, and, in particular, in its non-paper on the “ENP – a path towards further economic integration”. Available online: [http://ec.europa.eu/world/enp/pdf/non-paper\\_economic-integration\\_en.pdf](http://ec.europa.eu/world/enp/pdf/non-paper_economic-integration_en.pdf) (accessed on February 12, 2015).

Together with the cease-fire agreement between Ukraine and the Donbass separatists, concluded with the mediation of Russia and the OSCE in Minsk on September 5, 2014,<sup>3</sup> the EU and Ukraine firstly agreed with Russia's demand that they will postpone the implementation of the DCFTA part of the Ukrainian AA for one year (until December 31, 2015). Second, they also agreed to create a trilateral EU- Ukraine-Russia format for talks on the Ukrainian AA.<sup>4</sup> This has created a precedent that might also have direct implications for the EU's relations with Georgia and Moldova. In other words, the recent crisis raises the following key questions for the Eastern Partnership project:

1. Can Russia stop the implementation of association agreements within the Eastern Partnership by using military force (?); and
2. What measures could the EU take in response (?).

So far the EU has responded to Russia's military aggression against Ukraine by introducing sanctions against selected individuals and organizations responsible for undermining the territorial integrity of Ukraine, and by adopting economic sanctions on certain industries (restrictions in the field of foreign trade in oil and natural gas production and dual use technologies, limitation on the market access of Russian banks and major companies co-owned by the Russian government to European financial and capital markets).<sup>5</sup> The open question remains if and what else might be changed in the EU's present policy towards Russia and how that might affect the existing shape of the Eastern Partnership.

To identify possible measures that the EU could take as part of its policy towards Eastern Europe in response to the current Russian-Ukrainian crisis, it is necessary to first identify the nature of this crisis from the EU's perspective. Second, one must explore why and how this crisis matters to the EU. Naturally, there are differences between the political elites of EU member states when it comes to their respective perceptions and understanding of the current Russian-Ukrainian crisis.<sup>6</sup> As always when the EU is confronted with external challenges, it takes some time to form a critical mass of member states that arrive at a common understanding of what is at the stake and how to face the problem. But that's exactly about what the EU is and how it works.

<sup>3</sup> "Protocol on the results of consultations of the Trilateral Contact Group," signed in Minsk, 5 September 2014," OSCE. Available online: <http://www.osce.org/home/123257> (accessed on February 12, 2015).

<sup>4</sup> U. Speck, "Postponing the Trade Agreement with Ukraine: Bad Move, EU", *Carnegie Europe*, September 30, 2014. Available online: <http://carnegieeurope.eu/publications/?fa=56795> (accessed on February 12, 2015).

<sup>5</sup> For detailed information about the respective EU sanctions, see – "EU sanctions against Russia over Ukraine crisis", *European Union Newsroom*. Available online: [http://europa.eu/newsroom/highlights/special-coverage/eu\\_sanctions/index\\_en.htm](http://europa.eu/newsroom/highlights/special-coverage/eu_sanctions/index_en.htm) (accessed on February 12, 2015).

<sup>6</sup> P. Shakarian, "Sanctions against Russia are dividing Europe more than you think", *Russia Direct*, September 22, 2014. Available online: <http://www.russia-direct.org/opinion/sanctions-against-russia-are-dividing-europe-more-you-think> (accessed on February 12, 2015).

## 1. The Eastern European crisis from the perspective of European integration

We argue in this article that the recent Russian–Ukrainian crisis of 2014 and the Russian–Georgian crisis of 2008 are neither accidental nor short term episodes. They are necessary and objective outcomes that reflect long term European trends since the end of the bipolar conflict. The contexts of both crises above should be studied and taken into account when thinking about potential further steps in the EU’s Eastern policy, including the future of the Eastern Partnership program. If one looks back at what happened over the last two decades in Europe, one observes entirely different dynamics of integration in the continent’s Western and Eastern parts.

The collapse of the communist block helped to deepen the integration process in the Western part of Europe and it also pushed the EU to become more engaged in its neighborhood. The former Yugoslav republics look up to the EU as a source of stability, modernization and know-how, and, of course, also as a trade partner. Although we have seen several setbacks in their reform processes, including problems in following their EU course, they are clearly not trying to become part of the Russian Federation. As compared to the 15 members it had in 2003, the EU today boasts<sup>28</sup>. The successful model of integration of Greece, Spain and Portugal in the 1980s – which helped these countries overcome their fascist heritage – has pressed the EU to also open up the perspective of enlargement to the former communist countries (Copenhagen Summit, 1993). Preparations for the “grand enlargement” towards the East (2004–2007) spilled over into the EC/EU internal agenda, and, ever since the early 1990s, has pushed the EU to implement further institutional reform processes. Neither the *Lisbon Treaty* (2009) nor the institutional design of the present EU would have become a reality without the ongoing fragmentation of the Eastern part of Europe after the collapse of the communist bloc.<sup>7</sup>

In the end, looking back on the last two decades, through its efforts to prepare former Yugoslav Republic for their accession, the EU has emerged as the guarantor of peace and stability in the Western Balkans. It deepened its integration through the amendments of its basic treaties. The European Communities turned into the European Union after the adoption of the Maastricht Treaty in 1993. The Schengen acquis became part of the EU basic treaty in 1999. The euro as a common currency became operational in 2002. And, finally, the Lisbon Treaty, which brought significant institutional changes, entered into force in 2009. The EU successfully managed the “grand enlargement” in 2004 by including in its ranks eight former Eastern bloc countries along with Cyprus and Malta. The 2004 round of enlargement was followed by the accession of Bulgaria and Romania in 2007, and of Croatia in 2013. The fact is that the number of member states almost

<sup>7</sup> For further reading, see R. Bideleux, R. Taylor (ed.), *European Integration and Disintegration: East and West*. Routledge, 1996.

doubled over the past decade.<sup>8</sup> Finally, in 2009, the EU presented an offer to six former post-Soviet countries to deepen and expand cooperation within the framework of the Eastern Partnership initiative, including their economic integration through the implementation of AA/DCFTAs.<sup>9</sup>

Let us summarize the integration dynamics in the Western part of Europe over the last two decades. The European Communities became the EU we know today in 1993. As a point of fact, the EU is 22 rather than 63 years old! Schengen has been operating since 1999 (16 years!), the euro as a common currency has served as a cash currency since 2002 (13 years!). Before 2004, the EU had 15 members, but in the last 10 years the number of member states almost doubled to the current 28 (!). The EU was not an active player in the crisis of Yugoslavia in the 1990s because at the time it did not even exist in its current form. The Yugoslav War began in 1991, while the Maastricht Treaty, which transformed European Communities with no common foreign policy into the European Union with a Common Foreign and Security Policy, entered into force in 1993. However, without a modernization offer by the EU and the European perspective, the Western Balkans would continue to be a “powder keg.” There are many legitimate grounds for criticizing the EU; however, the EU remains a unique project in all known history of international relations. The fact that 400,000 strong Malta has the same voting rights as Germany with its 80 million citizens in EU legislative decision-making and in approving EU policies is absolutely unique; such a phenomenon cannot be found anywhere in the world and has never existed before in history. The EU in 2015 is a qualitatively different project – internally and externally – than the European Communities were before 1993. The integration dynamics of the EU over the last two decades and beyond should be reviewed seriously in order to understand, first, why the EU offered the Eastern Partners political association and economic integration in 2009 and, second, what might be the EU’s response to the current Russian-Ukrainian crisis.

The picture in the Eastern part of Europe is completely different. None of the integration initiatives aimed at bringing things in order within the former Soviet Union and/or a group of former Soviet countries over the last two decades could be labelled a successful project.<sup>10</sup> The disintegrated Soviet Union was supposed to be replaced by the Community of the Independent States, the creation of which was initiated by the presidents of Russia, Ukraine and Belarus in December 1991. Today, hardly anyone knows what the abbreviation CIS stands for. Russia and Belarus had tried to create a new common federal state in 1994. These days only Russian and Belorussian experts remember that project.

<sup>8</sup> For further reading, see E. Bomberg, J. Peterson and R. Corbett, *The European Union. How does it work?* Oxford University Press, 2012.

<sup>9</sup> “Joint Declaration of the Prague Eastern Partnership Summit. Prague, 7 May 2009”, 8435/09 (Presse 78), Council of the European Union, Brussels, 7 May 2009. Available online: [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/er/107589.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/er/107589.pdf) (accessed on February 14, 2015).

<sup>10</sup> O. Sushko, “The dark side of integration: Ambitions of domination in Russia’s backyard”, *The Washington Quarterly*, Vol. 27, Issue 2, 2004, pp. 119-131.



Yeltsin's Russia was not able to bring about any successful integration projects in the post-Soviet area. In 2004, Putin's Russia managed to come into conflict with Russia's largest ally, Lukashenka's Belarus, the same country with which Yeltsin had sought to enter into a federation. When we speak about the gas crisis today, let us not forget that Belarus was the first country that faced the prospect of seeing its natural gas supply from Russia cut off in 2004, and then again in 2007 and 2010.<sup>11</sup> The first gas war between Russia and Ukraine happened in 2006, and it was followed by another in 2009. Russia used military force in two other former Soviet Republics, during the civil war in Georgia in 1991 and in Moldova in 1992.<sup>12</sup> Russia used her military power also in August 2008 in Georgia, and in 2014 and currently against Ukraine, but this time its efforts have also included the annexation of Ukrainian territory. And let us not even mention Russia's trade wars with Belarus, Georgia, Moldova and Ukraine, as well as with other post-Soviet countries, seeing as how listing them all would take up too much space.<sup>13</sup>

Despite the fact that the Presidents of Belarus and Kazakhstan signed agreement on the establishment of the Eurasian Union in May 2014<sup>14</sup> – both of them pursuing their own agendas – nothing changes the fact that in the last 20 years and beyond Russia has proved unable to offer the post-Soviet neighbors a constructive agenda, normal and long-term cooperation based on the principle of equality in bilateral relations. It would be futile to seek an instance in the post-Soviet space over the past two decades that matches the Maltese–German example of cooperation among equals. And this is the substantial difference between where Western Europe and where the post-Soviet space stand today. Deeper and wider integration in the Western part of Europe juxtaposed with continuing fragmentation in its Eastern part – these are trends that have been shaping pan-European agenda, including EU–Russia relations, since the end of the Cold War.

A comparison of European integration – based on the EU project – and the attempts at integrating the “Russian world” in the post-Soviet region speaks for itself. The two different European worlds had to meet one day. And it was exactly the efforts at building two different European worlds that clashed in Ukraine in the years 2013 and 2014. It is wrong to refer to this episode as the “Ukrainian crisis”, for events in Ukraine are merely an episode in a larger crisis. This crisis has a systemic character and extends to the entire

<sup>11</sup> G. Caldioli, “Belarus – Russia Energy Disputes – Political and Economic Comparative Analysis”, *PECOB's Energy Policy Studies*, University of Bologna, 2011.

<sup>12</sup> For further details, see A. Mörike, “The military as a political actor in Russia: The cases of Moldova and Georgia”, *The International Spectator: Italian Journal of International Affairs*, Vol. 33, Issue 3, 1998, pp. 119-131.

<sup>13</sup> For further reading, see B. Nygren, *The Rebuilding of Greater Russia. Putin's foreign policy towards CIS countries*. Routledge, 2008; A. Wilson and N. Popescu, “Russian and European Neighbourhood Policies Compared”, *Southeast European and Black Sea Studies*, Vol. 9, No 3, September 2009, 317-331, etc.

<sup>14</sup> N. Gvosdev, “Russia's Eurasian Union: Part of a Master Plan”, *The National Interest*, June 7, 2014. Available online: <http://nationalinterest.org/feature/russias-urasian-union-part-master-plan-10619> (accessed on February 13, 2015).

continent. It represents a confrontation of the two European worlds as they have evolved and taken on distinct forms over the last two decades. As the efforts to coexist peacefully proved unsuccessful, and there can only be one Europe in long run, confrontation was bound to happen sooner or later. There are many myths about the EU's approach to post-Soviet Russia. What is – with a view from our current perceptions of the recent Russian-Ukrainian crisis – rarely known is that a decade ago there was a serious effort to establish a systemic dialogue and intense cooperation between the EU and Russia. This effort was called 'Common Spaces' and ran in the years of 2003–2006.<sup>15</sup> The idea of the Common Economic Space was that the EU and Russia will create a free trade zone within 15 years. But Russia decided to withdraw from the free trade deal with the EU at the end of 2006. This happened due to several reasons. Russia did not like the various color revolutions in Eastern Europe, while the leaders of most EU member states too a sympathetic view of these changes. The EU did not accede to the Russian request to give Gazprom privileged access to the EU's gas markets. And, of course, the best European friends of Russian President Putin at the time, President Chirac of France and Chancellor Schröder of Germany, have both since retired from politics.<sup>16</sup> Again, it needs to be stressed that in 2008 the EU's offer to post-Soviet countries in the Eastern Partnership included AA/DCFTA also because of Russia's decision to de facto withdraw from the free trade deal with the EU by the end of 2006. In his speech at the Munich Security Conference in February 2007, President Putin's main message was the following: We'll challenge the European system if it fails to accept Russia's privileged position (in Russian terminology, this is referred to as an "equal" position).<sup>17</sup> A little while later, in Georgia in August 2008, Russia made clear how she will challenge the European system. Let us emphasize that the EU offered a free-trade deal to Russia already back in 2003, long before it offered a similar deal to other post-Soviet states.

In the Georgian crisis of 2008, the EU did not respond by imposing sanctions against Russia. However, it responded by extending an offer to the countries of the Eastern Partnership to sign Association Agreements with DCFTA, which included provisions for their economic – though not political – integration.<sup>18</sup> The European Union didn't have a choice, it had to respond somehow. In other words its response to Russian tanks in Georgia in 2008 was a policy that facilitated the export of its body of law to the post-Soviet space. The conflict began in Georgia in 2008 and it continued in Ukraine in 2013

<sup>15</sup> See A. Duleba (ed) *Searching for New Momentum in EU-Russia Relations. Agenda, Tools and Institutions*. Bratislava: Research Center of the Slovak Foreign Policy Association, 2009.

<sup>16</sup> For a detailed analysis, see D. Trenin, "Russia Leaves the West", *Foreign Affairs*, Vol. 87, No 4, July-August 2006, pp. 87-92.

<sup>17</sup> "Speech and the Following Discussion at the Munich Conference on Security Policy, February 10, 2007, Munich", *President of Russia*. Available online: [http://archive.kremlin.ru/eng/speeches/2007/02/10/0138\\_type82912type82914type82917type84779\\_118123.shtml](http://archive.kremlin.ru/eng/speeches/2007/02/10/0138_type82912type82914type82917type84779_118123.shtml) (accessed on February 13, 2015).

<sup>18</sup> "Extraordinary European Council, Brussels, 1 September 2008. Conclusions", Council of the European Union, Brussels, 6 October 2008. Available online: [http://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/ec/102545.pdf](http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/102545.pdf) (accessed on February 13, 2015).

and later. Long before the mass protests in Ukraine started (November 2013), in response to the refusal of then-President Viktor Yanukovich to sign the AA with the EU, Russia imposed commercial sanctions on Ukraine (August 2013) in order to force Yanukovich's predecessor to step away from signing the AA with the EU.<sup>19</sup> All this happened after diplomatic messages from the EU capitals began to signal (in June 2013) that the imprisonment of former Ukrainian prime minister Yulia Tymoshenko might not prevent the signing of the association agreement with Ukraine at the Eastern Partnership summit in Vilnius in November 2013.<sup>20</sup>

A conflict pitting "Russian tanks" vs. "European legislation" erupted in Eastern Europe – after the Russian–Georgian war in August 2008 but long before the Ukrainian events started in 2013. This conflict has an objective and unavoidable nature as it mirrors the evolution of trends towards integration versus disintegration in two parts of post-Cold War Europe over the last two decades or more.

## 2. Interpreting the way the EU deals with the crisis

In the end, regardless of all difficulties, including the lack of flexibility when it comes to decision-making in the field of external relations, which is based on the consensus of 28 member states, the EU has emerged as the agenda-setter in Europe, including the continent's Eastern part. It was the EU's actions for the Western Balkans over the last two decades that made it the key international actor in/for Europe. The Western Balkans case illustrates the very nature of the EU as an international actor. The measure of the EU's strength in European affairs is not found in the number of its tanks and military aircrafts. Instead, what makes the EU the strongest foreign policy actor in Europe is the offer of modernization and access to the EU market it extends to neighboring countries.<sup>21</sup>

Before the Russian-Georgian crisis in 2008, the group of countries between the EU and Russia could hardly hope for anything even remotely similar to what the Western Balkans had received. Russia's military intervention in Georgia in 2008 came as a shock to EU leaders. The military operation lasted only a few days and the result was

<sup>19</sup> R. Olearchuk, "Russia accused of triggering trade war with Ukraine", *Financial Times*, August 15, 2013. Available online: <http://www.ft.com/intl/cms/s/0/99068c0e-0595-11e3-8ed5-00144feab7de.html#axzz3Re0Z6Oym> (accessed on February 14, 2015).

<sup>20</sup> Y. Mostovaya, T. Silina, "Russkiy plan, osmyslenny i besposhadnyy", *Zerkalo nedeli*, August 16, 2013. Available online: <http://gazeta.zn.ua/internal/russkiy-plan-osmyslenny-i-besposhadnyy-.html> (accessed on February 14, 2015); "O komplekse mer po vovlecheniyu Ukrainy v yevraziyskiy integratsionnyy process", *Ibid.* Available online: <http://gazeta.zn.ua/internal/o-komplekse-mer-po-vovlecheniyu-ukrainy-v-evraziyskiy-integratsionnyy-process-.html> (accessed on February 14, 2015).

<sup>21</sup> For an overview of the existing theoretical conceptualizations of the EU as an international actor, including the EU's capacity to project power in the international realm (as a civilian power, normative power, and/or market power), see Ch. Hill and M. Smith (ed.), *International Relations and the European Union*. Oxford University Press, 2008, 2011.

Russia's recognition of South Ossetia and Abkhazia. The EU did not apply sanctions against Russia. Instead, it revamped its Eastern policy. In September 2008 the EU member states authorized the European Commission to draft a new ambitious offer for Georgia but also for Armenia, Azerbaijan, Belarus, Moldova and Ukraine.<sup>22</sup>

In December 2008 the European Commission proposed to launch the Eastern Partnership program. Among many other new programs and instruments aimed at expanding the EU's cooperation with Eastern Europe, this program offered the respective countries the possibility to conclude AA/DCFTAs (hereinafter agreement).<sup>23</sup> Let us recall that the essence of this proposal was on the table already in March 2008, when it was presented to the other EU members by the foreign ministers of Sweden, Carl Bildt, and of Poland, Radek Sikorski.<sup>24</sup> In the period before the Georgia crisis their aim was to balance an initiative of Nicolas Sarkozy, then-president of France, to launch the Union for the Mediterranean during the French Presidency of the EU Council in 2008. In other words, they tried to make sure that Eastern Europe is not lost to EU policymaking. It is questionable whether the Eastern Partnership, with its offer for deeper integration with the EU, would have ever seen the light of day had it not been for Russia's intervention in Georgia in August 2008.

Based on the association agreements offered to the Eastern partners, the latter will adopt about 95 per cent of the EU's economic and trade related legislation and commit to respecting democratic rules and political freedoms.<sup>25</sup> Successful legal harmonization under AA/DCFA will in fact make them a part of the EU single market. The Association Agreement with the Eastern partner countries was designed based on the model of the European Economic Agreement (EEA) that the EU had concluded with Norway, Iceland and Lichtenstein. Thus for example the signatory countries are not member states, but they are nevertheless part of the EU single market.

There were strong signals from the EU capitals that the association agreement with Ukraine may be signed at the Vilnius summit in November 2013, despite ongoing differences between the EU and the Yanukovich government concerning the imprisonment of former Prime Minister Yulia Tymoshenko.<sup>26</sup> Russia was shocked as it

<sup>22</sup> "Extraordinary European Council, Brussels, 1 September 2008. Conclusions", op. cit.

<sup>23</sup> "Communication from the Commission to the European Parliament and the Council. Eastern Partnership", COM(2008) 823 final, Commission of the European Communities, Brussels, December 3, 2008. Available online: [http://eeas.europa.eu/eastern/docs/com08\\_823\\_en.pdf](http://eeas.europa.eu/eastern/docs/com08_823_en.pdf) (accessed on February 14, 2015).

<sup>24</sup> "Polish-Swedish Proposal, Eastern Partnership, 23 May 2008". Available online: <http://www.msz.gov.pl/Polish-Swedish-Proposal,19911.html> (accessed on February 14, 2015).

<sup>25</sup> Author's interview with the representatives of the DG Trade of the European Commission, who had been a member of the EU's negotiating team for the AA/DCFTA talks with Ukraine. The interview was conducted in Brussels on December 5, 2012. For an analysis, see A. Duleba, V. Ben?, V. Bil?ik, *Policy Impact of the Eastern Partnership on Ukraine. Trade, energy, and visa dialogue*. Bratislava: Research Center of the Slovak Foreign Policy Association, 2012. Available online: <http://www.sfpa.sk/dokumenty/publikacie/372> (accessed on February 14, 2015).

<sup>26</sup> See Y. Mostovaya, T. Silina, "Russkiy plan, osmyslenny i besposhchadnyy", op. cit.

had believed that neither Ukraine nor Georgia or Moldova would ever be willing to sign this agreement with the EU. Moscow responded by imposing trade sanctions against Ukraine in August 2013, with the aim of persuading then-President Yanukovich that signing the agreement with the EU is not a good idea.<sup>27</sup> In November 2013, President Putin agreed to provide a loan of 15 billion USD and lower gas prices to Yanukovich if he decided not to sign the agreement.<sup>28</sup> Finally, Russia began its military invasion of Crimea at the end of February 2014, a few days after Yanukovich was overthrown by the Maidan revolution. It is important to keep in mind that the protests in Ukraine first started in November 2013 because the leaders of the Ukraine at the time had decided not to sign the agreement with the EU.<sup>29</sup> Russia has shown that she is willing to use any means necessary to stop the economic integration of Ukraine with the EU.

The EU prime ministers, including those who opposed EU sanctions on Russia in response to the recent crisis, keep stressing that they have but one key objective: more jobs for their voters. More jobs could be achieved through more trade and investment. It might happen that the prime minister of Portugal would fully disagree with the prime minister of Poland when it comes to the evaluation of various political aspects of the EU's relations with Russia or Ukraine. However, the prime minister of Portugal and the prime minister of Poland agree that if there is any possibility in the EU's external relations with third countries for an agreement that facilitates the expansion of the EU's single market, e.g. if an agreement brings more trade, investments and jobs, then it is a good deal. In other words, the offer to Eastern Europe was made based on an underlying assumption that the deal is a win-win and would benefit everyone.

The prime ministers of all EU member states agreed that Eastern European countries should be offered association agreements coupled with DCFTAs. There are always groups of member states that securitize this or other issues in international relations, trying to put it on the common EU agenda. However, the actual practice of EU decision-making in the field of external relations shows that in terms of setting the agenda, the most successful members tend to be those who manage to link the issue of security with economic benefits for all member states. As a result, it is often the case that the expansion of the single market becomes the key common ground for finding a consensus among member states in the area of EU external relations.

The EU looks like a clumsy elephant on the international scene, and might be best characterized with the following image: It takes a while for it to start moving, once it

<sup>27</sup> "Ukraine and Russia. Trading Insults", *Financial Times*, August 24, 2013. Available online: <http://www.economist.com/news/europe/21583998-trade-war-sputters-tussle-over-ukraines-future-intensifies-trading-insults> (accessed on February 14, 2015).

<sup>28</sup> "Ukraine suspends talks on EU trade pact as Putin wins tug of war", *The Guardian*, November 21, 2013. Available online: <http://www.theguardian.com/world/2013/nov/21/ukraine-suspends-preparations-eu-trade-pact> (accessed on February 14, 2015).

<sup>29</sup> "Ukraine's revolution and Russia's occupation of Crimea: how we got here", *The Guardian*, March 5, 2014. Available online: <http://www.theguardian.com/world/2014/mar/05/ukraine-russia-explainer> (accessed on February 14, 2015).

gets going, however, it is very difficult to stop it.<sup>30</sup> The EU responded to Russian tanks in Georgia in 2008 with a consensual decision to expand its single market to the post-Soviet area. In other words, the EU elephant decided to move into the post-Soviet area after the war in Georgia. And that is why the EU is directly engaged in the Russian-Ukrainian crisis, and should adjust both its institutions and policies to tackle the problem. This will definitely take some time, but it will happen the same way as it has been happening over the last two decades.

### 3. Implications for the Eastern Partnership

The only possible direction for an effective EU policy, including potential upgrades to the Eastern Partnership as a consequence of the Russian–Ukrainian crisis, is the expansion of the single market and, ultimately, the enlargement of the common space where the four fundamental European freedoms apply. The EU cannot give up on what it is nor on the way it has been dealing with European crises in the past or the way it has implemented the European integration process for over three decades. The EU most certainly cannot stop its enlargement policy towards those Eastern European nations that are willing to join the project. The only force that can stop the enlargement of the EU in Eastern Europe might be the incapacity of the partner countries' societies to accept the painful but necessary reforms, and/or the failure of their political elites. Russian tanks absolutely cannot stop this process. Further upgrades in the Eastern Partnership should be identified in the same way as it was been done in the past, by resetting contractual arrangements or sets of arrangements with Eastern neighbors in a way that facilitates the expansion of the EU single market in Eastern Europe.

When it comes to tactics, the key issue that should be discussed in the EU capitals concerning the fourth Eastern Partnership summit in Riga in 2015 is member states' position on trilateral talks with Russia and Ukraine over the Ukrainian AA/DCFTA. First, the EU and Ukraine should not give up on the substance of the association agreement, or accept any changes of any previously agreed upon provision of the AA/DCFTA. The EU cannot afford any deal with Russia at the expense of the sovereignty of partner countries. This should be the clear redline for EU diplomacy. The political aspects of AA should not be at issue in any trilateral talks. What might be up for discussion, assuming Russia presents reasonable concerns with respect to trade, social and/or economy-related issues, is to extend transitional periods in case of select trade commodities included in the DCFTA. Sanctions against Russia should continue until solutions are found for the Donbass and Crimea that the Ukrainian party also deems

<sup>30</sup> The author was inspired by the metaphor of “the EU as an elephant on the international scene” by the writing of M. Emerson with N. Tocci, M. Vahl and N. Whyte, *The Elephant and the Bear. The European Union, Russia and Their Near Abroads*. Brussels: Centre for European Policy, 2001. Available online: <http://aei.pitt.edu/32565/1/4>. *The Elephant and the Bear.pdf* (accessed on February 14, 2015).

acceptable. The EU could recognize Crimea as part of Russia only on the proviso that Ukraine does so first. Nevertheless, the EU should consider the possibility of promoting talks between Russia and Ukraine on resolving the technical infrastructure problems of people living in Crimea, especially since the electricity, natural gas and water supply of the peninsula completely depends on Ukraine and its resources. Moreover, such efforts ought to keep in mind that Russia should needs to compensate both the moral and material losses of the Ukrainian state, as well as of Ukrainian nationals and companies in Crimea. A normalization of relations with Russia should not occur unless the latter halts her military aggression and ceases any military threats against other Eastern Partner countries.

Second, the challenging task for EU diplomacy is to use trilateral talks for bringing a more realistic perspective to the FTA talks that will be launched with Russia/Eurasian Union. The task should be two-tiered, e.g. the EU has to be able not only to sustain the association agreement with Ukraine, but also to motivate Russia to engage with the EU on the FTA deal. The EU can do anything except for behaving in a way that runs afoul of its basic character. In other words, it should come up with an agenda that includes positive offers to Russia. This should only happen however, within the broader framework of moving Russia closer to an agreement with the EU that might facilitate the expansion of the EU single market. Furthermore, the EU should also consider a combination of AA/DCFTA with partner countries with an option for concluding sectoral agreements, should Ukraine or any other partner country be willing to proceed more quickly with the harmonization of the EU *acquis* as it pertains to a given sector. The full implementation of AA/DCFTA will take considerably longer for EaP countries than it did in case of the Visegrad countries, when the process lasted seven to eight years. If realistically it will take around ten years to harmonize Ukrainian law with EU law, then that is too much time. It would be a strategic mistake for the EU if in the meantime it did not strengthen its contractual relations with partners via sectorial contracts aimed at achieving the main goal, i.e. the implementation of the comprehensive AA/DCFTA.

When it comes to the EU's strategy, the main objective concerning the AA/DCFTA should be twofold: First, to upgrade the agreement with an offer that includes the prospect of potential EU membership for Ukraine, Moldova and Georgia, that is the partner countries which are in the process of implementing their association agreements. Second, there needs to be a focus on the implementation of the agreements, including more robust assistance funding following at least the model of the PHARE program offered to the Visegrad countries in the 1990s. The EU should invite non-association partner countries, e.g. Armenia, Azerbaijan and Belarus, to engage in sectoral cooperation, following the model of the ENP Plus tools as proposed by Germany on the eve of its Council's Presidency in 2007, including the prospect of concluding sectoral agreements that would

facilitate the integration of the non-association partner countries into given sectoral parts of the common area of the EU's four basic freedoms.<sup>31</sup>

And, finally, the EU should upgrade the Eastern Partnership by adding a missing security component, even if that does not include military terms specifically. First, it should expand the Energy Union it started to develop with the aim of strengthening its energy security by involving Ukraine and Moldova, which have joined the European Energy Community. The second element of a security component of the Eastern Partnership might include the protection of state borders of associated partner countries as a part of efforts to promote their territorial integrity and sovereignty. Anyway, the EU has to come to realize that the Eastern Partnership should be more of a policy driven process than a purely technocratic exercise in the area of harmonizing national legislation with the *acquis communautaire*. The EU's capacity to sustain its fundamental character as a European integration project is being tested by the Russian-Ukrainian crisis. The current crisis definitely raises not only the question of what Europe will look like 20 years hence, but also the issue of assessing what the EU has achieved within the last two decades. There is too much at the stake.

<sup>31</sup> For analysis of the ENP Plus proposal, see A. Duleba, L. Najšlová, V. Benc, V. Bilčík, *The Reform of the European Neighbourhood Policy. Tools, Institutions and Regional Dimension*. Bratislava: Research Center of the Slovak Foreign Policy Association, 2008. Available online: <http://www.sfpa.sk/dokumenty/publikacie/217> (accessed on February 14, 2015).



# DRAWING THE BALANCE

SVETLANA GLINKINA

## THE EURASIAN ECONOMIC UNION: RISKS AND CHALLENGES ON THE WAY TO FORMATION

The post-Soviet space is the unconditional priority of the external relations of the Russian Federation (the RF). Not on account of its economic relevance (about 1% of the world GDP and 0.8% of world trade – excluding Russia), but because of its long-term significance for the country's development. The CIS market is seen as an expansion of the domestic market, which is extremely necessary both for the accelerated development of manufacturing industries and to correct accumulated structural and technological strains in the domestic economy. At the current level of machinery and technologies, the products of domestic machine engineering, along with innovative products and services, are in higher demand in the CIS than in more remote foreign regions. The post-Soviet space may be the main locus of economic expansion for Russian Foreign Direct Investments (FDI), new technologies, intellectual services and infant industries. The CIS region is an important additional source of labor and natural resources, as well as a key transit area, which follows international transport corridors.

The establishment of the Customs Union of Russia, Belarus and Kazakhstan in 2010, the launching of the Common Economic Space (the CES) between the three countries, and, finally, the formation of the Eurasian Economic Union (the EAEU) on January 1, 2015, identified the main trend of the post-Soviet integration process. The present article is devoted to an analysis of some of the numerous existing risks and challenges on the way to the implementation of the integration project.

**Keywords:** Regional integration, the Eurasian integration project, customs union, common economic space, the Eurasian Economic Union, the effects of integration, Russia, Belarus, Kazakhstan.

### **A few words concerning the idea of Eurasian unification**

The analysis shows that there are significant differences in all member states of the Eurasian Economic Union in terms of their respective understandings of the ultimate goal of the integration project that is under implementation. There may be many explanations for these differences. Our suggestion is that one of these may be the lack of a super-idea that could serve to unify the participants of the integration project. The technocratic approach to Eurasian integration, which predominates in the countries involved, does

not provide an ideological content; the “priority of an economic component and the need for a serious approach to the calculation of the balance of long-term gains and losses” cannot serve as an ideology [1].<sup>1</sup> The Director of the Institute of Economics at the Russian Academy of Sciences (the RAS), R. Greenberg rightly observed: “As an economist, I know for sure that there are things which are more important than the economy. Despite all the debt problems that exist in the European Union, there is an idea there which unites the peoples. I am afraid that this is lacking here” [2]. And this, in turn, is a major obstacle for the development of Eurasian integration – both its deepening and expansion.

The very concept of “Eurasian integration” is interpreted by politicians and experts in different ways. Conventional wisdom holds that we are dealing with a special area of reintegration. When attempting to explain the nature of this reintegration, politicians and experts often refer to the common past of the peoples living in the Eurasian region. However, the common historical experience does not manifest itself only in a joint nostalgia. It sets guidelines for all subsequent integration efforts in this area. Just as in the case of athletes, their previous records affect all their future careers, they affect the athletes’ desire to not perform worse than previously, even if they are not necessarily breaking the record.

Commonalities and connections inherited from the USSR create the illusion that reintegration processes in the emerging common space will be easy. It appears that it is much easier not to create new connections forged through a painful search, but instead to only fill already existing ones with new content. In fact, however, the goal of the reintegration of space has proved much more complex than the formation of the European integration from scratch. Past experience is capable of exerting a much more negative impact than a lack of common experience. So, the previous hierarchy of mutual relations between Moscow and the rest of the republics, the standard relationship of the former dominating the latter, as well as the aspiration to independence on the part of the latter, and the fears and prejudices regarding one another, continue to influence and strain the relationships in the region at the present stage as well.

<sup>1</sup> Thus, in an article the Director of the Eurasian Development Bank’s Center for Integration Studies, E. Vinokurov, refers to “Pragmatic Eurasianism.” Such a vision of Eurasianism may be as follows: “Pragmatism in politics does not preclude the presence of underlying values. Eurasianism is an ideology. It is about its specific content, about the technocratic approach to political and administrative processes, the priority of the economic component, and the need for a serious approach to the calculation of the balance of long-term gains and losses.”

All the more so since the interactions between these countries largely retained the features of the previous agreements between their leaders,<sup>2</sup> some of whom, moreover, have managed to hold on to their positions since Soviet times. “Tenderness over the common Soviet past in other ex-Soviet Republics” – F Lukyanov writes – “is not perceived as positively as it is in Russia. In Russia, it involves mourning over the loss of power, while the others are celebrating the emergence of their own statehood. It is clear that any post-Soviet country has many people who lost a great deal in the last 20 years and who would gladly return to the “golden age”. But as generations who do not remember the last century, grow older. And certainly, these dreams will not be met with understanding by the ruling classes in any of the successor states of the former Soviet Republics – naturally, they are not interested in their own delegitimation”. [3]

Russian-centricity is inherent in the Eurasian space, it is a given that is hard to ignore. “It is natural that Moscow will increasingly be accused of imperial ambitions,” – writes Russian political analyst A. Karavaev. “Especially in the West. But the paradox is that in Eurasia it is impossible to build the integration processes involving Russia in a different way. Kazakhstan and Russia are not equals in the same way as France and Germany are. It can be as long as you want to talk about the political equality, but in reality there is only one subject of integration, which gathers lands around itself”. [4] As a result, no matter how hard Russia tried to convince them otherwise; no matter its efforts to speak time and again about the impossibility of resurrecting the Soviet Union; no matter how it sought, even sincerely, to rebuild relationships with its neighbors in a new way,<sup>3</sup> [1] to various degrees the situation keeps returning to the problem of Russia’s domination over the other successor states. Under such conditions, the real state of the integrating center, the qualitative content of processes occurring there, turn out to be crucial for the future of the integration project. “In the 1920s the young Soviet Russia offered the peoples of the former empire the great internationalist and modernization project, but now such a uniting project does not exist” – writes Kazakhstani political scientist M. Laumulin. “The generation of those ‘born in the USSR’ are all, heart and soul, for the association, but after the common reflection a natural question arises: But with whom? With the power that has accepted the worst of Western capitalism;

<sup>2</sup> The problems, specific to the Eurasian integration, are compounded by the nature of the political regimes prevailing in the space of the Customs Union/the Common Economic Space (the CU/ the CES). Integration necessitates that certain aspects of sovereignty be transferred to supranational bodies. But such a delegation of powers can be accomplished only by an integration in which there is a real division of powers. The former Soviet space is dominated by the regimes of sole reign, which allow the presence of one host (dominant) in the country. The authoritarian nature of political power in these countries reinforces the irrationality and the unpredictability of interstate relations in situations specific to personalistic regimes, which hinder the development of coordinated positions and decisions.

<sup>3</sup> “...It is highly desirable that Russia should not become the sole locomotive of integration. ‘Eurasia is not synonymous with Russia’” – this a fundamental point. Despite the obvious dominant role of Russia as the largest economy in the region, the Eurasian project – at least its political dimension, cannot be “Russian-centric”. Other active players are necessary as well. In this regard, the conservation of the important role of Kazakhstan is critical.

which has assimilated a very bad and nasty version of bourgeois culture; which demonstrates manifestations of xenophobia and everyday domestic racism; which is in demographic and technological decline? With a country whose economy is controlled by oligarchic mafia groups? Quite reasonably, they may point out that they already have these things in Kazakhstan, and for the most part they would be correct.” [5]

One may debate such a tough assessment, but on the whole it cannot be denied that the Kazakh expert is mistaken in arguing that if as a result of the implementation of the integration project we intend to get a powerful regional center of economic and political influence, then it is impossible to solve this problem without finding the “unifying idea”, without designing a large modernization project. Until now, the integration process was limited only by pragmatic issues concerning the removal of cross-border barriers impeding the creation of a common market, primarily a common commodity market. Nostalgia for past greatness and the logic of survival each played their part. But this, obviously, is not enough, especially in the higher stages of integration, in particular within the framework of the newly created Eurasian Economic Union.

### **Integration without modernization?**

All countries, that is the current and potential participants in the Eurasian integration project, are faced with the need to modernize their economies, while they experience, in this case, a lack of financial and intellectual resources for the implementation of such a project.<sup>4</sup>

Theoretically, there is a direct link between the processes of modernization and integration: Taking the path of technological and structural modernization requires the establishment of closer ties with the partner countries, and closer ties expand the base of resources available for modernization. However, experience from around the world shows that the formation of regional trade and economic blocs does not automatically generate stable development rates in the participating countries, nor does it necessarily produce progressive changes in their economies or a rapid increase in the volume of mutual trade. Such aspirations would be especially difficult to meet in light of the dominant economic role of raw materials in two countries among the four involved in the Eurasian Economic Union (the EAEU), namely Russia and Kazakhstan. The role of the raw materials sector, or resource sector, limits the return on integration interaction: The key oil and gas industries of Russia and Kazakhstan are focused primarily on foreign markets. The success of integration requires the diversification of the economy and the reduction of

<sup>4</sup> What we mean by economic modernization are qualitative changes in the economy, based on the introduction of new technologies of production and management, leading to greater efficiency of the national economy, greater competitiveness in domestic and global markets, and greater resistance to internal and external shocks.

dependence on raw materials, and this problem can only be solved through a deep modernization of the economy.

Integration helps generate the prerequisites needed for modernization in the form of an expanded market space, increasing competitive pressures on companies and national jurisdictions, rising innovation on the part of the subjects of the combined markets, the efficient use of available resources, an expansion of consumer choice, and a freer exchange of knowledge. [6] To attain these prerequisites, large investments, new technologies and coordinated modernization programs are required.

The link between modernization, which began in the countries of the Eurasian Economic Union (the EAEU), and the Eurasian integration process is still weak, since it is based on technological borrowing from third countries and focuses mainly on import substitution. When the existence of the Customs Union creates favorable conditions for the participating countries to exchange among themselves either commodities (raw materials) or products created on the basis of technologies of third countries, the result is a rather absurd situation.

So far, the necessity of transitioning into an innovation economy is not mentioned in the EAEU program documents among the goals of the development of the common integration space. There is no concept for providing a united space within the Common Economic Space (the CES) for the respective countries' scientific, education and innovation sectors, which would set the following: deadlines for the stages of modernization; the estimated structure of the economy, and sources of investments for innovations. [7]

The model of catch-up development allows for this modernization. However, only within certain limits since it focuses on creating conditions for marketing products rather than cross-border production and the creation of technological chains that form a substrate of the integration association.

In a situation where mutual modernizing impulses between the countries of the EAEU are clearly insufficient for the sustainable improvement of their economies, it is necessary to develop new approaches to mutual cooperation. The influx of foreign technology accelerates the modernization of the relevant industries, but objectively complicates the coordination process of economic renewal in the countries of the Commonwealth and industrial cooperation between them, since the centers of technological and product innovations are located outside the group that is being integrated. This may hamper the formation of the Eurasian Union and increase the risks of weakening the incentives for the mutual integration of these countries.<sup>5</sup> [8] In our opinion, the extensive adoption of

<sup>5</sup> In this context, a question arises concerning the emergence of "a trap of technological adoptions", which leads to the preservation of technological backwardness in the member countries of integrated supranational communities.

technologies from third countries should be combined with the restoration of their own technological basis of integration, at least in individual sectors of production.

For the countries of the EAEU, the transition to accelerated modernization is urgent for the creation of a common modernizing space and, on this basis, for the construction of the innovation economy.[7] The innovative economy in the EAEU should be built both at the level of countries and regions and through joint sector projects. Countries that partake in integration projects should pay special attention to coordination and to the combination of national priorities in the scientific and technical sphere, as well as to the formation of “technological corridors” by joint efforts, in which global competitiveness of certain selected sectors of the economy will be achieved mainly through technologies developed in these countries.

To solve these problems it is necessary:

- 1) to develop interstate purpose-oriented programs of innovative development and to determine the sources of their financing;
- 2) to implement, on a bilateral and multilateral basis, institutional and financial mechanisms of support and implementation of scientific research and innovative projects, and the formation of cross-border innovative chains, which make it possible to implement the principle of added innovations, wherein innovations created in any country of the integration association are complemented and improved in other countries of the given association;
- 3) to improve the conditions for innovative business, to ensure the protection of intellectual property of small and medium-sized enterprises, to accelerate the adoption of interrelated technical standards;
- 4) to create a legal and regulatory framework that governs the distribution of income and interstate property – including both tangible and intangible assets – acquired during the implementation of joint innovative and investment projects that were carried out within the framework of both multilateral and bilateral programs of cooperation.

In this case, preconditions arise for the coordinated modernization (that is coordinated by the objectives, priorities and mechanisms of implementation) of the economies of the EAEU countries with a significant share of creative component in it, that is carried out and implemented in the country or in a group of integrating countries of the technological, food and institutional innovations that have received international recognition and that is bringing (them) a certain rental income.

A program of coordinated modernization led by Russia could be fully implemented within the framework of the EAEU, and could moreover also prove attractive to many other post-Soviet countries since, in our assessment, it would allow for solving problems that the countries could not resolve before through bilateral and multilateral cooperation.

To the full extent, questions arise 1) about the possibility of organizing the process of expanded production mainly on the basis of own domestic resources and demand, with simultaneous expansion of the interaction with the outside world and increase of the competitiveness of the entire region; 2) about the decision concerning the strategic task of overcoming the peripheral nature of the Eurasian region's economy by joint efforts, and about the elimination of the excessive economic and social asymmetry in it; about the provision of targeted assistance to less developed participants and the obligations of the latter to participate in joint projects; 3) about the formation of a system for redistributing the benefits (compensation of losses) that accrue from integration projects.

The implementation of such a strategy requires that the capabilities and interests of the partner countries in the EAEU are taken into account when it comes to programs aimed at modernizing Russia's economy. In the meantime, many Russian programs aimed at specific sectors and regions are planned without taking into account the Customs Union//Common Economic Space (CU/CES) as a factor of development, and without taking into account the needs and interests of the partners in the EAEU.

The policy of import substitution in respect of products that have been successfully delivered by our partners to the Russian market for many years is continuing; transportation, which provides an outlet for Kazakhstan to the Russian and other markets, is developing insufficiently. Should these trends persist, then the EAEU may share the sad fate of the Council for Mutual Economic Assistance (CMEA), which became defunct in 1990.

### **The competition of integration strategies**

A serious problem in the practical implementation of the development strategy of Eurasian regional integration and the formation of the Eurasian Union (EAEU) is an increasing competition among regional integration projects in the post-Soviet space. The US, the EU and China are investing considerable efforts in the region to further their own geopolitical and geo-economic interests, offering Russia's neighbors projects involving international cooperation, the implementation of which binds them closer to alternative centers of power both by economic and political means.

Thus, within the framework of the "The New Silk Road" project, which was presented to the world community in July 2011, the US provide for the creation of a new Mega Region through the merger of Central and South Asia. In the framework of this project, cohesion is achieved on the basis of deepening economic, energy, transportation and communication links between the countries of Central Asia (the CA) on the one hand, and Afghanistan, Pakistan and India on the other. Historically, the transportation and energy infrastructure of the post-Soviet states of Central Asia (CA) was directed northwards (to Russia). The obvious task of the projects newly implemented with US assistance is the reversal of transport corridors and power transmission lines in the



Central Asian countries (such as Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan) from north to south (to Afghanistan, Pakistan, India). The New Silk Road Strategy (the NSRS) includes the promotion of trade relations and a transport corridor along the following route: Central Asia-Afghanistan-South Asia; the launch of a gas pipeline along the following route: Turkmenistan-Afghanistan-Pakistan-India (TAPI); energy supplies from Central Asia to Afghanistan and South Asia (CASA-1000 project) and others. The strategy is implemented through the countries of the region, through regional economic mechanisms and programs of cooperation with the support of international organizations. It is obvious that from a geoeconomic and geopolitical perspective, this project is about the development of competitive mechanisms by the USA versus Russia and China in the given region.

The United States of America has never hidden its rejection of any integration projects – even those in which only a limited number of post-Soviet states are involved – implemented in the context of the Customs Union/the Common Economic Space (the CU/CES) by Russia, Kazakhstan and Belarus. Former Secretary of State H. Clinton stated this clearly shortly before her resignation, just a few hours before meeting with Russian Foreign Minister Sergei Lavrov on December 6, 2012, at a press conference in Dublin. “There is a move to re-Sovietise the region” – She said. – “It’s not going to be called that. It’s going to be called a customs union, it will be called Eurasian Union and all of that. But let us not be deceived. We know what the purpose of this is and we are trying to find effective ways to slow it down or to prevent it”. [9] A. Cohen, an expert at the Heritage Foundation, expressed his concerns in connection with the prospect of the EAEU’s creation that the “new authoritarian [...] Russian sphere of influence” can further restrict the access of the US and NATO to maritime and land routes in the region, which is “not what the US and NATO want”.

Russia’s main competitor in the Eastern European and South Caucasian subregions of the CIS is the European Union, which has been implementing the “Eastern Partnership” project (the EP) since 2009. The EP project marks a further development of the former European Neighborhood Policy applied to the CIS countries (Ukraine, Belarus, Moldova, Armenia, Georgia, Azerbaijan), but on a much more solid legal basis (three types of binding international agreements) and directed at forming a multilateral model of interaction between the participating countries, or among the EP member countries themselves and in their interactions with the enlarged EU-28. An announcement was made about the establishment of the “Economic Community of Neighbors of the EU”, in which Russia does not participate, and the close “political association” of the EP countries with the European Union, which implies their movement will track the changes in the foreign policies of the EU and the US.

The analysis of the “Eastern Partnership” program highlights its ambition to compete with Russian efforts to further integration among the countries of the CIS region. [11] Thus, for example, a precondition for “Eastern Partners” to be allowed to enter into in-

depth agreements on free trade areas with the EU is the refusal of the latter to cooperate with Russia in the Customs Union, which emerged as one of the reasons for the complications in Russian-Ukrainian relations.

The potential simplification of the visa regime between the EU and the Eastern Partners, the signing of agreements on the readmission of illegal migrants, as well as discussions about a project to create a unified system of border control – all these are measures that could lead to tighter border controls and reduced access to these countries from Russia. In the meanwhile, the Russian side is interested in the preservation of a visa-free space in the CIS, which provides the citizens of the Commonwealth with considerable benefits and promotes the formation of a common regional labor market.

Though it is not promising participants of “The Eastern Partnership” program full membership in the EU in the foreseeable future, thanks to the introduction of the delicate instruments of regulatory reforms, the European Union gradually draws the countries of “The Eastern Partnership” into the legal framework of the EU. The notion of “harmonizing” the legislation of the EP states is interpreted by the EU bodies as the need to harmonize the legal systems of these countries with the already operative “normative power” in the European Union, or with the legislative framework called *acquis communautaire*. [12] In fact, we are talking about a unilateral EU policy concerning the transfer of its normative base, its technical and other standards and regulations concerning the CIS countries.

In parallel with the work aimed at binding the CIS countries to the European Union in terms of their economies, there are also constant efforts underway to steer the countries in the EP’s towards NATO membership. Thereby, in practice, the geopolitical idea of a western controlled “buffer zone” between the EU and Russia begins to take shape. If the implementation of the EP project is successful (and I must admit that so far everything planned in Brussels is on schedule), it will be a serious impediment to the expansion of Eurasian integration.

China, which is gaining economic power, competes with Russia not only in Central Asia but also in the European CIS countries, successfully debugging forms and mechanisms of interaction in the post-crisis period. Its goal is economic expansion into the domestic markets of the CIS countries, the use of their rapprochement with the European Union for its own access to the markets of the united Europe, and the establishment of control over important raw material resources.

In 2013, China proposed a new integration strategy to enhance economic cooperation in Eurasia, which was given the name “The Silk Road Economic Belt” (The SREB). Speaking on September 16, 2013, at Nazarbayev University in Astana, the General Secretary of the Communist Party of China, Xi Jinping, introduced the underlying conceptual framework and formulated a five point action plan: 1) enhanced political

coordination between the countries of the region; 2) intensification of the construction of a single road network; 3) promoting trade by eliminating trade barriers and reducing the costs of trade and investments, increasing the rate and quality of economic transactions in the region; 4) increasing foreign exchange flows through the transition to payments in national currencies; 5) strengthening the role of public diplomacy and the expansion of direct ties between the peoples of the countries of the region.

By the beginning of 2015, the project was supported by over 30 countries, which are home to more than 60% of the population of the Earth, and which produce 30% of global GDP. Among them are Iran, Russia, India, Pakistan, Myanmar, Kazakhstan, Tajikistan, Kyrgyzstan, Uzbekistan, Turkmenistan and others. China has signed 11 agreements on free trade areas with 19 countries and regions; negotiations on seven such areas are underway with 23 states. As a result, important steps are being taken towards solving the problem of creating a large-scale free trade area from the northwestern provinces of China and Central Asia to Central and Eastern Europe. This FTA, in turn, can be connected to the Asia-Pacific Free Trade Area, as the General Secretary of the Communist Party of China, Xi Jinping, noted at the APEC summit in Beijing in November of 2014.

Beijing assigns the SREB zone the role of a future launching pad for the radical reform of the global dollar architecture. In the interests of solving this problem, China is expected to create a network of regional financial institutions of development and to optimize the flow of financial resources. Among these institutions are the Asian Infrastructure Development Bank, whose memorandum of establishment was signed in October 2014 by representatives of 21 Asian states, and the Infrastructure Development Fund of neighboring states, established by China in November of the same year, including the states of Central Asia. The authorized capital of the aforementioned institutions is 100 and 40 billion dollars, respectively.

Experts estimate the total cost of the SREB project at 21.1 trillion USD. Hence, even though the Chinese banking system is already engaged in financing this project, the country's leadership has urged Chinese banks to provide loans or to allot credits to countries participating in the SREB, within the framework of the financial corridor of the project. Government permission has been obtained for the use of the funds of the BRICS Development Bank (that is the bank of the BRICS countries) within the framework of the SREB. China hopes that up to 8 trillion dollars of private capital will be invested into the infrastructure projects over the next decade.

The Silk Road Economic Belt project and the Eurasian Economic Union (EAEU) will obviously become competitors if their benefits are considered solely on an economic basis, and that is what both sides are fond of pointing out. However, they may coexist and even complement each other. It is no coincidence that when presenting his project, the Chairman of the PRC, Xi Jinping, spoke about the prospect of forming a single economic space on the basis of the Shanghai Cooperation Organization (the SCO) and

the EAEU, which does not exclude the probability of a merger of the two projects under Chinese control.

\* \* \*

We only discussed three of the current challenges facing the implementation of the Eurasian integration project with the participation of Russia, Kazakhstan, Belarus (and which was also joined by Armenia as of January 1, 2015). However, at the same time, there are many risks and challenges. They can be divided into **“the conditionally permanent”** (fierce competition of the integration projects in the post-Soviet space and the aggressive expansion of external powers outside the post-Soviet space; the Russo-centric configuration of unification; the structural problems of the economy; the high level of heterogeneity of the territory in terms of socio-economic development; the nature of the dominant political systems in the region, which have proved unwilling to delegate even minor aspects of the authority that is currently excessively centralized at the national level to supranational bodies, and so on), as well as **“the conditionally variable”** (growth in the world market, the rates of economic growth in the participating countries, exchange rate fluctuations, inflation, the level of debt, political instability and the like). It is obvious that under unfavorable conditions the imposition of various types of risks might call into question the fate of the integration project as a whole.

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LÁSZLÓ PÓTI

## EVOLVING RUSSIAN FOREIGN AND SECURITY POLICY: INTERPRETING THE PUTIN-DOCTRINE

Writing about Russian foreign policy is always topical, but particularly in recent years as Russia has markedly increased its foreign policy profile, undoubtedly the most powerful Russia in world affairs since the demise of the Soviet Union. Russia has also made radical shifts in some traditional areas of its foreign policy. Additionally, in 2008 Russia will elect a new president who will formally put an end to the Putin-era<sup>1</sup>. Thus, a preliminary evaluation of the Russian Federation's second president's foreign policy performance seems appropriate at this juncture.

In this article I do not aim at a systematic analysis of the 8 years of Putin being in office, rather, I would like to focus on those points that reveal the novel content of what sometimes is termed "Putin-doctrine" with some emphasis on East-Central Europe. In doing so, I will start by analyzing the contours of the new Russian security policy taking shape since 2003. Further, I will examine Russian-European relations and within that I put a special emphasis on the Russian policy towards Central Europe. Finally, I try to characterize the tremendous changes in Russian foreign policy since 2006.

### **The Contours of a New Russian Security Policy – The "Ivanov-Doctrine"**

Shortly after Putin's coming to power, first as prime minister, then as president, Russia adopted three new strategic documents: the national security strategy (January 2000), the military doctrine (April 2000), and the foreign policy concept (June 2000). These documents are characterized, first, by the fact that they are standard modern documents of the post-Cold War era, second that they preceded the 9/11 attack, and third, that they were elaborated in the Yeltsin-period. All these factors suggested a need for renewal by the new president of Russia, and this moment arrived in late 2003. The Russian defense leadership held a so-called enlarged meeting – with the participation of president Putin – on October 2, 2003, and made public a document that presented the Russian security

<sup>1</sup> Although anything can happen in politics, but there seems to be more and more evidence that Putin – in accordance with the Russian constitution – will not run for the presidency for a third term, in spite of the fact, that there have been numerous speculations and even initiatives to, in some way or another, circumvent this constitutional restriction

perspective with unprecedented openness and in an unprecedentedly detailed manner, partially reaffirming, partially changing the previously mentioned security documents.

The 73-page document was entitled “The topical tasks of the development of the armed forces of the Russian Federation<sup>2</sup>.”

The document contained six chapters and numerous illustrations covered the following items:

- The new phase of the development of the Russian armed forces
- The role of Russia in the world’s military-political system
- The evaluation of the threats affecting Russia
- The character of contemporary wars and military conflicts
- The tasks of the Russian armed forces
- The priorities of development of the Russian armed forces

The main elements of the defense minister’s report can be summed up, as follows. First, according to the authors of the document current world politics can be characterized by several key trends. Globalization tendencies have produced new threats (e.g. proliferation of weapons of mass destruction, inter-national terrorism, drug-trafficking, etc.). Military force is applied more and more outside traditional military-political alliances. Instead, ad hoc coalitions have increased in importance, with economic aims now often serving as war cause. In line with this, the role of non-state actors has grown in formulating world politics and the foreign policies of individual countries.

Second, the document identifies the regions that are considered as belonging to the “natural interests” of Russia from the point of view of national security. These are: Europe, the Middle East, Central Asia and the Pacific. In this regard, what is of most interest, is the fact that – if taken at face value – Russia does not identify itself as a global power but rather as an actor interested in regions smaller in scope, from which whole continents are missing (like Africa or South America). This self-definition keeps Russia in a much more realistic dimension, as far as her international role is concerned, and makes her vision somewhat similar to the self-perception of the European Union.

Third, in addition to the usual classification of the threats as external and internal, the defense minister’s report introduces a quite new category – “trans-border” threats. These are considered a growing concern and are defined by the document as a kind of threat, which by its form is internal, but by its substance (sources, instigators, executors) is external. Examples include the support of groups aiming at later actions in Russia, support of groups whose purpose is the overthrow of Russia’s constitutional order, hostile information activities, organized crime, international drug trafficking, etc.

<sup>2</sup> Актуальные задачи развития вооруженных сил российской федерации,” 11 Октября 2003 [http://www.redstar.ru/2003/10/11\_10/3\_01.html].

Fourth, probably the main message of the report – formulated in different but consistent statements – is that the role of military power in safeguarding security not only remains, but is even growing. According to one characteristic formulation, to safeguard “the security of the Russian Federation by only political means (membership in international organizations, partnership ties, political influence) is more and more impossible.” In comparison to the strategic documents of 2000, this is the biggest change.

Fifth, as to nuclear weapons, the document does not say anything new in comparison to previous strategic documents (it is obviously not the task of such a report), which already included the first use of nuclear weapons under well-defined conditions. What is novel in this regard are the new arguments in favor of the role of these weapons as a means of deterrence. According to the logic of the authors of the report the use of military force without Security Council mandate has given impetus to the proliferation of weapons of mass destruction, nuclear weapons included. Furthermore, nuclear weapons are considered by more and more states as a usable kind of weapon, and the threshold of the use of nuclear weapons has been lowered lately. The conclusion is that in this newly evolving situation Russia should rely considerably on its nuclear capabilities, which means Moscow’s explicit return to nuclear deterrence.

Sixth, as to NATO, – although the media made much of it – the report does not offer too much that is new, but certainly uses unusual wording. The document, besides briefly describing the existing framework of cooperation between NATO and Russia, does state that there are differences of opinion between the two sides regarding two issues, the Eastern enlargement of the alliance and NATO’s participation in military conflicts. The most controversial statement asserted that Moscow expects that the alliance “take out the directly or indirectly anti-Russian components of its military planning,” or if NATO remains in the future “a military alliance with offensive doctrine” then Russia carries out “radical changes in its military planning... including the Russian nuclear strategy.” No doubt, what we have here is nothing other than the blunt expression of how the lessons of the NATO air campaign against Yugoslavia made their way into Russian security thinking. The unusual wording is not a return to the rhetoric or the practice of the cold war era, but rather a crystal-clear expression of the difference of opinion and perception on major developments in international security.

Finally, as to the reform of the armed forces, the main message of the report is that the reduction of the army has reached the level where further significant reductions are not expected. Putting it into perspective, it means that after reducing from 2.75 million men (1992) to 1.6 million (1996), reduction in force should bottom out at the level of one million by 2005.

The real importance of this document can be summarized as follows. First of all, it can be excluded that this was just an ad hoc political signal from the Russian political leadership. It is known from several sources that the document had been under preparation



for a longer period of time, with the involvement of a whole range of experts (General Staff, Ministry of Defense, the presidential office, parliamentary fractions) and not only from the officialdom, but also from the influential Karaganov-body, the Council for Foreign and Defense Policy (Sovet Vneshnei i Oboronnoi Politiki), and academic institutions dealing with international relations and security policy. After the publication of the Ivanov-report no serious academic discussion took place challenging the views expressed in the report, on the contrary, a number of analytic statements were issued along the same lines. For the same reason, it cannot be asserted that the report could have served the individual political ambitions of Defense Minister Ivanov, or in a wider sense the interests of the military-industrial lobby, or the hardline military. Nor can it be interpreted as a kind of PR-activity timed for the 2007 December elections. President Putin's presence at the meeting (his introductory and closing remarks) is also an indication that the document reflects the well thought out position of the whole Russian political-defense leadership.

To sum up, while not rewriting formally the still valid series of strategic documents accepted in 2000 the current report brings in one fundamental message: if the world is evolving in the way it is perceived by the authors of document – increased likelihood of the use of military force, increased role of the nuclear weapons, decreased role of the main security institutions, the legitimization of preventive strikes – Russia cannot stop it, but rather accepts these new rules of the game and will act accordingly. What we are witnessing is not a Russian return to cold war, or the beginning of a new assertive Russia, but rather the proliferation of the new post-bipolar security rules of the game and their adoption for use by Moscow. It is the essence of the Ivanov doctrine.

In early 2007, the Russian Security Council announced that the military doctrine would be revised in order to reflect the “strengthening of military blocs, especially NATO”<sup>3</sup> in international relations, but this has not happened yet.

It is also worth noting that right after the Beslan hostage-taking tragedy of 1-3 September 2004, President Putin delivered a speech that contained important foreign policy messages, elaborations on the 2003 doctrine. The first to be mentioned is that the Russian president expressed his nostalgia for the Soviet Union in an unprecedentedly straightforward way. This was something more than just a personal emotion. In the context of the speech, it was clear that he wanted the restoration of the lost international position of the Soviet Union to the maximum possible level. There was also a brand-new element in the speech, namely, anti-Westernism. Once he concretely mentioned the West in connection with which Russia “cannot defend itself,” and at another place the context also suggested a major anti-western attitude.

<sup>3</sup> Viktor Yasmann, “Russia: Reviving the Army, Revising the Military Doctrine,” 12 March 2007 [www.rferl.org].

This was followed, in the wake of the Beslan events, by widely echoed announcement of Chief-of-Staff Baluevskii that Moscow was ready to make preventive strikes on terrorists anywhere in the world. Later, this was softened, in a way that such an operation can only be performed with the previous consent of the leadership of the given country.

### **Solving the Dilemma of Russia's Policy toward Europe: The "Missing Middle"**

The main problem of the Russian policy towards Europe in the post-bipolar world could be characterized as the "dilemma of the missing middle." This means that Russia, at different levels, had very differing means of asserting its interests.

While, at the level of global politics, through its veto right in the UN Security Council, and at the level of the post-Soviet space, through its traditional relations, multi- and bilateral leverages Russia could substantially influence the security situation, at the "middle level," in Europe, Moscow was deprived of almost any means to assert its interests throughout the nineties.

Moscow tried to handle this problem by way of institutionalizing its presence in Europe. Russia was, of course, a member of the OSCE, and later became a member of the Council of Europe, but the main effort was to build institutional relations with the two main hard security organizations, namely NATO and the EU.

The first major step was made in connection with NATO, when in 1997 the two sides signed the NATO-Russia Founding Act, providing privileged relations with Moscow in comparison to other partners of the Alliance. This document introduced a new institution, the so called NATO-Russia Permanent Council which was also unprecedented in the Alliance's external relations. In the Putin-era, in 2002 a further step strengthened Moscow's position in Brussels: under a new name, the NATO-Russia Council was upgraded, and since then on, Moscow became a quasi-member of NATO. Although without a veto, Russia got the right to participate in the decision-making process of NATO in a number of fields, putting her on equal footing with the full-scale members in the so called "format of 20."<sup>4</sup>

As to EU, formally-institutionally, Russian-EU relations have been well elaborated and structured. The Partnership and Cooperation Agreement (PCA) signed in 1994 came into force in December 1997 and not only substituted for the old Soviet-EC agreement, but went beyond simple trade regulation and increased and widened the scope of

<sup>4</sup> It differed from the 1997 format, which was characterized as "19+1 format," and meant that on a given issue first the 19 members of the Alliance elaborated a common position which was later discussed with Russia. In the new format all issues were discussed without a prior common NATO-stance.

interaction between the two entities. In 1999, both Moscow and Brussels went further in concretizing their respective policies, by adopting the EU's Common Strategy on Russia, on the one hand, and the "Medium-Term Strategy for the Development of Relations between the Russian Federation and the European Union (2000-2010)" of the Russian government, on the other. This evolution led to a mutually positive conclusion on both sides that Russian-EU relations had reached a new era. The PCA regulates trade relations on the basis of MFN treatment and of the gradual elimination of quantitative restrictions, enhances economic cooperation in the field of energy, transport, environment etc. and promotes justice and home affairs cooperation in the field of drug trafficking, money laundering and organized crime. Finally, it introduced increased and institutionalized political dialogue at all levels.<sup>5</sup>

The EU's Common Strategy was due to expire by June 2003, and the EU decided to extend the document by one year. Later – on 14 June 2004 – it was decided that the Common Strategy would not be further extended and it is being replaced by the development of the so called "four spaces" agreed at the St Petersburg summit with Russia in May 2003, namely, the "common economic space," the "common space of freedom, security and justice," the "common space of external security" and the "common space of research and education."

Indeed, judging by the basic documents regulating Russian-EU relations, other high level declarations and the ongoing practices, one can conclude that the basis for future partnership exists, and this basis consists of profound interests on both sides. However, there is a striking asymmetry between the two sides' focus: while Russia wants this partnership predominantly for economic reasons, the EU's main interest lies elsewhere, in the field of soft security: stability, democracy building, ecology, etc.<sup>6</sup> This is explained, first of all, by the different interests of the two entities. Europe – meaning the enlarged EU – for Russia appears as an economic partner, which is a traditional perception of the EU. It is the region that is the main consumer of Russian raw materials and energy products. On the other hand, aside from its exports of natural resources, Russia is a negligible economic partner, but a highly important security factor. Although the possible

<sup>5</sup> This latter comprises annual meetings including two presidential summits, the cooperation council at the ministerial level, cooperation committees at senior official levels, and sub-committees on technical issues. The latest, seventh presidential summit took place in Moscow on 17-18 May 2001.

<sup>6</sup> The priority areas of the Action Plan which was elaborated for the implementation of the EU's Common Strategy are, as follows: foreign policy, economic dialogue, civil society, rule of law, democracy, the "Northern Dimension" [[www.eurunion.org/news/speeches/2000/001116/c.htm](http://www.eurunion.org/news/speeches/2000/001116/c.htm)]; Chris Patten, commissioner for external relations, in a recent speech summarized the areas of cooperation, as follows: trade and investment, health and environment, organized crime, Russia's place in the world [[www.europa.eu.int/comm/external\\_relations/ceeca/news/ip\\_01\\_72.htm](http://www.europa.eu.int/comm/external_relations/ceeca/news/ip_01_72.htm)]; finally EU's proposed agenda for the latest summit enlists the following topics: investment climate, WTO accession, trade issues, environmental protection, nuclear safety, organized crime, stability in Europe, disarmament and non-proliferation [[www.europa.eu.int/comm/external\\_relations/russia/intro/index.htm](http://www.europa.eu.int/comm/external_relations/russia/intro/index.htm)].

areas of cooperation between EU and Russia have already been addressed<sup>7</sup>, Russia's first and foremost goal in its partnership with the EU is to adopt a modernization model with the help of which it wants to become a decisive actor in international politics. Within the big "area asymmetry" (economy vs. other issues) there is an additional asymmetry, namely, in the field of economic relations, first of all in trade relations. The enlargement of the EU has further increased the basically asymmetric relationship between the two entities. Before the enlargement, the EU represented Russia's largest trading partner accounting for 36.7% of Russia's imports and 33.2% of its exports, while Russia was the EU's sixth largest partner with 3.3% of its imports and 1.9% of its exports. After enlargement the numbers are: 48.26% (the EU share of Russian imports) and 56.72% (the EU share of Russian exports), 9.09% (imports from Russia) and 5.3% (exports to Russia) in 2005, the first full year of the enlarged EU<sup>8</sup>. This means a significant increase in all areas of trade, further deepening Russia's dependence on the EU, while for the EU, Russia has become trade partner No. 4.

According to the regime of the PCA there are two highest level meetings per year. These regular events have demonstrated that the institutional links are well established and function well. In the course of these meetings, a wide range of issues have been touched upon and considerable progress has been made. In the Putin era the EU-Russia summits were markedly productive. The first summit of the Putin era – the fifth after the PCA entered into force – was held in Moscow in May 2000 and proved to be a "business as usual" type of meeting without any real novelty. The following summit resulted in two innovations in the form of two dialogues: first it started the so-called energy dialogue, that put negotiations about this important sector on a regular basis, and second, it opened a new dimension in cooperation in the domain of security policy by adopting a joint declaration on "strengthening dialogue and cooperation on political and security matters in Europe."<sup>9</sup> The seventh summit in May 2001 went on to continue cooperation in the security and economic field. As to the first, the two sides reaffirmed to make "foreign and security policy matters a regular feature of the agendas,"<sup>10</sup> as to the second, this summit initiated something that has become the major characteristic feature of EU-Russian relations by now, namely the "policy of spaces," it decided to formulate the concept of common European economic space. The following summit was the first that occurred after the terrorist attacks on the US in September 2001, so it was largely dominated by the topic of terrorism. Among others, a separate statement was adopted on international terrorism. The issue of the common European economic space, the energy dialogue and the dialogue and cooperation on political and security matters were also

<sup>7</sup> During the visit of the EU troika (Russian word in EU vocabulary!) to Moscow in February 2001, a "Russian-EU forum on foreign and security policy" was organized where foreign minister Ivanov and EU high representative Solana also addressed the issue. See: [www.strana.ru/worldview/press/2001/02/16/982312673.html](http://www.strana.ru/worldview/press/2001/02/16/982312673.html)

<sup>8</sup> [http://ec.europa.eu/comm/trade/issues/bilateral/countries/russia/index\\_en.htm](http://ec.europa.eu/comm/trade/issues/bilateral/countries/russia/index_en.htm)

<sup>9</sup> Joint declaration on strengthening dialogue and cooperation on political and security matters in Europe, [www.europa.eu.int/comm/external\\_relations/russia/summit](http://www.europa.eu.int/comm/external_relations/russia/summit)

<sup>10</sup> [http://www.europa.eu.int/comm/external\\_relations/russia/summit](http://www.europa.eu.int/comm/external_relations/russia/summit)

kept high on the agenda. The sixth summit in the Putin era – in November 2002 – produced a major result by the EU’s formal recognition of Russia as a “market economy” which was an important milestone on the road to WTO membership. The next (10th) high-level meeting brought about a breakthrough in the long standing issue of Kaliningrad by adopting a set of measures called the Facilitated Transit Document (FTD) scheme valid from 1 January 2003.

Institutionally, the most important development – up until now – occurred during the summit in St. Petersburg in May 2003 which created the Permanent Partnership Council instead of the previously existing Cooperation Council, thus providing a more effective strong body. It can be regarded as a kind of equivalent of the NATO-Russia Council, although with much less Russian involvement in the decision-making process.

In Russia’s European policy East-Central Europe occupies a special place. East-Central Europe literally occupies a central position in the system of relations between Russia and Europe. This position is unique: the one-time Soviet allies have joined the basic West European institutions, and by now they have become the borderland of the West towards the post-Soviet space. As it is usually referred to in a well-known maxim, East-Central Europe’s status has changed from the Western periphery of the East, to the Eastern periphery of the West.

There are two opposing views on the issue whether there is any Russian strategy towards the region. The first – and this is held by the majority of the Russian academic and foreign policy establishment – is that there is no Russian strategic approach toward Central Europe, the only difference between them is that part of this group urges the elaboration of a strategic vision, another part does not consider it necessary. The opposing view holds that Russia has a well formulated strategy towards Central Europe, and its content can be summarized as “new imperialism.” The main proponent of this approach is Janusz Bugajski, who wrote a book on the Russian East-Central European relations entitled *Cold Peace*<sup>11</sup>. The American analyst summarizes in six points Russia’s alleged strategy in Eastern Europe: to achieve preeminent influence over foreign policy orientation and security policy; to strengthen economic benefits and monopolistic positions, while increasing dependence on Russian energy supplies; to limit the scope of western institutional enlargement in the European CIS; to rebuild a larger sphere of influence, and finally, to weaken transatlantic relations.<sup>12</sup>

<sup>11</sup> Bugajski is one of the best known American analysts on this topic and an exemplifying figure of the radical critique of Russia; see Janusz Bugajski, *Cold Peace. Russia’s New Imperialism* (Westport, Connecticut: Praeger, 2004). The fact that Bugajski is not a marginal holder of this view is supported by the endorsement of the book by Zbigniew Brzezinski, who wrote that “Russia’s policies towards the countries of the former Soviet Bloc are still being influenced by an ominously imperialist nostalgia” [[www.greenwood.com/catalogue/C8362.aspx](http://www.greenwood.com/catalogue/C8362.aspx)].

<sup>12</sup> This includes European post-Soviet states, the Baltic states, Central Europe and the Balkans.

The evolution of Russian-East-Central European relations in the post- Cold War era<sup>13</sup> has been a process of their “standardization.”<sup>14</sup> This has included the following elements that characterize the present state of affairs, as well. First, ECE has radically been devaluated and has found its naturally low place in the system of priorities of Russian foreign policy.<sup>15</sup> Second, as a matter of fact, the region has lost its autonomous value from the Russian perspective, and is approached indirectly, i.e. in the context of Russian European or NATO policy. Third, instead of the previous bloc approach Russian policy handles these countries individually or regionally – that is, differentiation has come to the fore. Fourth, these relations have been demilitarized, and, de-ideologized. Finally, all major problems that had to do with the Soviet past (Warsaw Treaty, Soviet interventions, the consequences of troop withdrawal, the inherited debts) have been settled. The standardization process evolved by the following trajectory:

- 1990-91 – Attempts at limited sovereignty under the “Kvitsinskii-doctrine”
- 1992-94 – Democratic neglect under the “Kozyrev-doctrine”
- 1995-2000 – Rediscovery of the region in the NATO-EU enlargement context
- 2000-present – Geo-economic approach under the Putin-doctrine

The current stage of the Russian policy towards East-Central Europe is best characterized by the geo-economic approach under the Putin-doctrine. The geo-economic approach is embodied, first of all, in active economic policy towards the region. The main fields of this new “economized” Russian policy are, first of all, the energy and finance sector.<sup>16</sup>

There are two opposing answers to the question whether energy policy is a special Russian foreign policy instrument, and if so what is its content? One school of thought says that – as one analyst put it – “For the Kremlin, energy has come to represent the principal tool in foreign policy, with Moscow using energy to interfere and influence domestic political processes across Europe and elsewhere, and halt geopolitical shifts such as expansion of NATO and the EU.”<sup>17</sup> Others describe Russian energy policy as

<sup>13</sup> On this topic the author has published an article “The Rediscovered Backyard: Central Europe in Russian foreign policy,” *Eager Eyes Fixed on Eurasia*, 21st Century COE Program Slavic Eurasian Studies, no. 16-1 (Sapporo: SRC, 2007).

<sup>14</sup> The expression belongs to Gerhard Mangott, “Russian Policies on Central and Eastern Europe: An Overview,” *European Security* 8:3 (1999).

<sup>15</sup> For example, as opposed to the 1993 version of the foreign policy concept, the 2000 version does not refer to Eastern/Central Europe as a region of vital Russian interest. See, *Diplo- maticheski Vestnik* 3 (1993).

<sup>16</sup> The existing Yamal pipeline in Poland, and another planned gas pipeline through Poland and Slovakia, as well as the increased Russian share of Hungary’s chemical industry are illustrative examples of this.

<sup>17</sup> Borut Grgic, *Russian Energy Strategy: Risk Assessment for Europe*, Occasional Paper, no. 4 (Ljubljana: Institute for Strategic Studies, 2006), p. 5.

“energy imperialism,”<sup>18</sup> or as an “energy weapon,”<sup>19</sup> and recommend a tough EU response in order to let Russia “understand its future as Europe’s preeminent energy supplier is at risk”.<sup>20</sup> The representatives of this approach also refer to the problem that Russia does not ratify the Energy Charter (practically depriving western companies from participating in the Russian energy market), and to unkind gestures of high-level Russian representatives who publicly entertained the idea of redirecting Russian supplies to North America and China.<sup>21</sup> In a similar vein, Polish Defense Minister Radoslaw Sikorski commented on the planned Northern Pipeline between Russia and Germany through the Northern Sea in an unusually harsh tone: “Poland has a particular sensitivity to corridors and deals above our head. That was the Locarno tradition, that was the Molotov-Ribbentrop tradition ... We don’t want any repetition of that.”<sup>22</sup>

The other approach suggests that “the fear of Russia is exaggerated and there is no evidence of a malicious political intent in recent Russian energy decisions.”<sup>23</sup> I subscribe to this second approach. Russia makes no secret that it wants to use its energy potential for its domestic and international rise. As the Russian official Energy Strategy reads: “Russia owns significant energy resources ... that is the base for economic development, instrument of domestic and foreign policy. The role of the country in the international energy markets defines, to a large extent, its geopolitical influence.”<sup>24</sup> In my opinion, one can hardly find anything wrong in this statement. They represent clearly the national interests of Russia.

The main question is if Russian energy policy has been used for direct political purposes, or for blackmail against Europe and Central Europe. There has not been any case, when Russia could have used this instrument in Europe. There have been cases when it was used for direct political influence, but exclusively within the CIS-space, and only vis-à-vis such countries that wanted to enjoy preferential low prices and were willing to accept special political relations with Moscow (Belarus, Ukraine, Moldova). In my opinion, the Russian-Ukrainian gas dispute of 2005 was overwhelmingly misinterpreted by politicians, and misrepresented in the media. Although the Russian steps against Ukraine did not lack a certain political element (the timing before the March 2005 parliamentary elections) and spectacular moves (the well-publicized stop of supply), the whole issue, in its essence, was a local business dispute over the price and the

<sup>18</sup> Victor Yasmann, “Russia: Moscow Gets Tough with the EU,” *RFLRL Feature Article*, 5 June 2006.

<sup>19</sup> Keith C. Smith, “Security Implications of Russian Energy Policies,” *CEPS Policy Brief* 90 (January 2006).

<sup>20</sup> Citation from Michael Emerson, director of CEPS in Ahto Lobjakas, “EU: The Energy Dilemma – with or without Russia,” *RFLRL Feature Article*, 22 March 2006.

<sup>21</sup> Alexandr Miller, head of Gazprom warned EU ambassadors in Moscow, in “Gazprom smotrit na Zapad,” *Nezavisimaia Gazeta*, 7 June 2006.

<sup>22</sup> Cited in Cheney, “Russia is Blackmailing Europe,” *Guardian online*, 14 June 2006.

<sup>23</sup> Citation from Julia Montanaro-Jankovska in Ahto Lobjakas, “EU: The Energy Dilemma – with or without Russia,” *RFLRL Feature Article*, 22 March 2006.

<sup>24</sup> “Энергетическая стратегия России на период до 2020 года” (Moscow, May 2003).

Ukrainian practices of re-export for extra profit. Russia did not decrease its delivery to Europe (including Central Europe), and had no intention of blackmailing Europe. On the contrary, it is in Russia's best interest to maintain stable energy relations with Europe. Russia can hardly find alternative markets without immense investments that would put into question the whole endeavor.

The Russian policy towards Europe successfully handled the dilemma of "the missing middle." With regard to NATO and EU strong institutional structures have been established, while in the region of the former Warsaw Treaty alliances Russia managed to position itself strongly in the field of economy.

### **2006: A Year of Tremendous Changes in Russian Foreign Policy**

2006 was a year of tremendous changes in Russian foreign policy. These changes resulted in a qualitatively new phase of Russian foreign policy. This new quality can be grasped in three aspects: the forming of a new Russian national ideology, the new emphases of Russian global foreign policy and in the radical shift of the Russian CIS-policy.

As to the first, it was deputy prime minister, and defense minister Sergei Ivanov, who made public the basis of the new Russian national ideology. It is composed of three main components: sovereign democracy, strong economy and robust military force.<sup>25</sup> "Sovereign democracy" was originally coined by Vladislav Surkov, the main Kremlin ideologist, in order to counter Western criticism of Russian democracy usually referred to as "*managed democracy*." Sovereign democracy means, first of all, a special Russian model of democracy, and secondly this concept holds that there is no political sovereignty without economic sovereignty. As to the latter, it does not exemplify isolationism. According to Surkov, economic sovereignty should be used to integrate Russia into the world economy. Although another deputy prime minister and possible successor to Putin, Dmitrii Medved'ev distanced himself from the wording of sovereign democracy – claiming that any adjective used before democracy brings in a special taste as if it were not genuine democracy – it seems that this concept will be a basic one in the elite's new ideological stance.

In Russian global foreign policy, 2006 has witnessed further increased emphases on the following issues:

- New balance of power with the United States,
- New arms control talks with the United States,
- Increased importance of military force,

<sup>25</sup> "Sergei Ivanov vydvinul kontseptsiiu natsional'noi idei Rossii," 13 July 2006 [www.km.ru].



- Efforts to have Russia recognized as an energy superpower,
- No compromise on territorial issues.

As to the new balance of power with the United States, this is not a completely new aspiration by Moscow, but Putin formulated this thesis strikingly during the Russian ambassadors' meeting in June 2006 by saying that "the principle 'what is permitted to Jupiter is not permitted to an ox' is unacceptable for Modern Russia."<sup>26</sup>

As to new arms control talks with the United States, Putin considered the post-cold war era the period of "stagnation" and called for a new round of such negotiations.

Increased importance of military force, has been on the rise since the publication of the so-called Ivanov-doctrine in 2003, but the 2006 presidential message to the parliament formulated for the first time that the Russian armed forces should be capable of fighting simultaneously at three levels: globally, regionally and in local conflicts.<sup>27</sup>

To have Russia recognized as an energy superpower by the outside world, has been one of the most successful foreign policy issues of Moscow in recent years. In spite of the fact that Russia's membership in WTO is still pending, or that Moscow is still not inclined to ratify the Energy Charter with the EU, it is beyond doubt that Russia has established itself as a superpower with an additional pillar, leaving behind the era when she was a one-dimensional – only military – superpower.

The "no compromise" Russian approach on territorial issues has to do with the Russian Far East. Moscow has settled all major territorial disputes, or minimized them with almost all its major and minor neighbors in Europe and in Asia, so the only remaining problem of this kind remains with Japan. There are three moments that shed light on why Moscow has rejected for the long run any compromise solution on the "Southern Kuril islands" in Russian or "northern territories" in Japanese terminology. Firstly, Moscow has made public grand investment plans in the Kuril Islands and Sakhalin. Secondly, the first ever sizable (5,000 troops) strategic military exercise was organized on the Kamchatka peninsula – an exercise which is clearly, not an antiterrorist exercise. Thirdly, the Russian border patrol reacted harshly when trying to get hold of a Japanese ship in Russian waters disputed by Japan killing one of the crew.

The final component that signals the new quality of Russian foreign policy has to do with Moscow's policy in the post-Soviet region. 2006 witnessed a double radical shift in this policy in terms of the Russian approach to the frozen conflicts in the region and the pricing policy of energy materials. In the case of the previous, the traditional Russian policy used to aim at keeping the status quo, thus influencing the countries involved.

<sup>26</sup> RFL/RL NEWSLINE 10:116 Part I, 28 June 2006.

<sup>27</sup> [http://www.kremlin.ru/appears/2006/05/10/1357\\_type63372type63374type82634\\_105546.shtml](http://www.kremlin.ru/appears/2006/05/10/1357_type63372type63374type82634_105546.shtml)

After the declaration of independence by Montenegro, however, Moscow first publicly formulated that these frozen conflicts should be solved by referenda, thus changing the decade and a half long status quo. The price of Russian energy delivered to the post-Soviet region, had traditionally been politically calculated, meaning much cheaper price levels in comparison to the world market, expecting loyalty in exchange. Announcing a radical departure from this approach Putin proposed at the ambassadors' conference in June 2006 a switch to "principles applied in world economy and trade." The switch to a market economy base in energy pricing means a brand new policy in the post-Soviet region and places Moscow's capability to assert its interest on a far more effective base.

In sum, the above described changes that have become the dominant and characteristic features of Russian foreign policy, mean that Russia's role in world politics should be reevaluated. One has to get rid of the still surviving stereotypes. Russia is no longer a declining, disintegrating country suffering from permanent identity crisis. One has to take into account Moscow more than ever in modern international politics. Russia should be perceived as an evolving great power with ever clearer identity, with an increasingly strong economic base, knowing its ambitions and able to assert them more effectively.

### **Conclusion: Cold War Vs. Normal Great Power**

In early 2007 President Putin participated in the prestigious Munich international security conference, where he delivered a remarkable speech. He made use of the conference format, and in a very open explicit manner – unusual for politicians – elaborated on the Russian perception of world security affairs. Most western commentators qualified it as a return to Cold War rhetoric. Actually, he simply summarized well-known Russian security policy concerns, and visions on unipolarity, US unilateralism, international law and the use of force, NATO-expansion, missile defense, etc. The main elements of the Russian vision on international politics and the role Moscow is to play are, as follows:

- ***the revision of the Yeltsin-era military doctrine:*** accepting the new rules of the game in international security policy, allowing for the use of force more flexibly, increasing the role of more professional army in safeguarding national interests, reaffirming nuclear deterrence, allowing for preventive strikes;
- ***a new kind of anti-Westernism:*** counterbalance the US in military terms, and keep Western Europe away from internal human rights issues;
- ***double track handling of NATO:*** on the one hand, integrating into it, on the other hand, criticizing its enlargement and the redeployment of military hardware closer to Russia;
- ***returning to Europe:*** solving the dilemma of the "missing middle" by institutionalizing relations with NATO and EU, and by economic presence in the enlarged Europe;

- ***elaborating a national ideology***: based on the thesis of sovereign democracy strong economy and robust armed forces;
- ***building a second pillar of global importance***: becoming an energy superpower;
- ***modernizing relation in the CIS-region***: rejecting the strategy of reintegration, building influence on a market basis.

This is the core of the Putin-doctrine. To put it simply, the Putin-doctrine means the reconstruction of Russia both domestically and internationally as a normal great power.

### Afterword

It is very instructive to look back at one's study written many years ago and to test the validity of the conclusions made in the end. My article's main message was, at the time, that "Russia's role in world politics should be reevaluated. Russia should no longer be perceived as a declining, disintegrating country suffering from permanent identity crisis, rather Russia should be perceived as an evolving great power with ever clearer identity, with an increasingly strong economic base, knowing its ambitions and able to assert them more effectively". This general thesis seems to hold still now, Moscow's moves since 2007 have explicitly shown signs of an old-new regional grand power with an ever stronger identity and clear goals.

Let us see the details, though.

***A new kind of anti-Westernism*** – the national security strategy, the foreign policy concept and the new military doctrines adopted since 2007 do support this point. Russia not only counterbalances the US in military terms, but acted militarily in 2008 and in 2014 in Georgia and Ukraine respectively. In terms of human rights issues Russia not only kept Western Europe away from its internal affairs, but in its foreign policy concept of 2013 went further and declared its own human rights model, plus began to systematically criticize Western practices.

***Double track handling of NATO*** – well, this thesis does not hold by now. There is no double track policy and more on behalf of Russia: while rapprochement efforts towards the alliance have withered away, criticizing NATO's enlargement and the redeployment of military hardware closer to Russia has become stronger. The main security concern of Russia has to do with the missile defence system elements of which already exist in Poland and Romania constituting a major stumbling bloc in Russian-NATO relations.

***Returning to Europe*** – well, again this one also seems to be outdated. Moscow could not solve the dilemma of the "missing middle" by institutionalizing relations with NATO and EU. Its economic presence in the enlarged Europe has not increased.

***Elaborating a national ideology*** – a formal national ideology is still to be elaborated, the notion of sovereign democracy has practically been forgotten, instead of a strong economy Russia has been facing a structurally not renewed monocultural economy while armed forces also show a controversial picture.

***Building a second pillar of global importance*** – Russia has, in deed, become an energy superpower but not on a global scale. Its energy potential can be used in a limited geographical sphere, primarily in the post-Soviet space and partially in Europe whilst Russia has still not become a major energy player in Asia. Further, the shale gas revolution with all its consequences has weakened Moscow's position in the world.

***Modernizing relations in the CIS-region*** – this has been the biggest miscalculation from my side. Moscow has not only not rejected the strategy of reintegration in its sphere of influence, but has come to the fore with its major integration project the Euro-Asian (Economic) Union. Ukraine's case is very illustrative of how important this project is perceived in the Kremlin.

## TRACKING RUSSIAN FDI IN HUNGARY

**1. Introduction**

There is a growing body of literature that deals with outward foreign direct investment (OFDI) from Russia and the international activities of Russian multinational enterprises (MNEs). However, despite the significant public attention devoted to Russia, and relatively widespread fears of Russian capital, there is very little academic research on the presence of Russian capital in Central and East Europe. Only a few studies have examined in detail the entire region or even parts of it (Pelto et al., 2004; Weiner, 2006; Chetverikova, 2010; Kalotay et al., 2014). Moreover, only a few CEE country studies have been conducted, including studies on Bulgaria (Zashev, 2005a), Hungary (Weiner, 2011a, 2011b, 2013), Poland (Liuhto, 2002; Runiewicz, 2005), Latvia (Zashev, 2005b) and Lithuania (Zashev, 2004). Although Hungary is among the exceptions, an English-language study has yet to be published.

This paper has two main purposes. The first is to review what the various official statistics tell us about Russian FDI in Hungary (Section 2). The other is to arrive at a more comprehensive understanding of major Russian FDI projects in Hungary, by analysing company data in meticulous detail (Section 3). In these case studies, we consider the main characteristics of Russian investments in Hungary, including, among other things, (1) the industries targeted by Russian investors; (2) the way in which Russian investors enter the market (greenfield projects, acquisitions or joint ventures); (3) the motivations behind investment decisions; (4) the failure or success of investment projects; (5) the ownership structures of the investing entities (with special attention to potential links to the Russian government); (6) the Russian share in the investment; (7) the role of indirect FDI/trans-shipment (investment through a third country). We investigate whether the top Russian non-financial MNEs (Table 1<sup>2</sup>) are present in

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<sup>2</sup> The tables can be found after the References section.

Hungary, and whether there are significant FDI projects on the horizon. We only briefly touch on the prevailing Hungarian attitude towards Russian investments.<sup>3</sup>

## 2. What do the statistics say about Russian FDI in Hungary?

The central banks of both Hungary and Russia (MNB and CBR, respectively) and the Russian Federal State Statistics Service (Rosstat) provide data on the actual size of Russian FDI in Hungary:

- the MNB has provided data on Russian FDI flows into Hungary since 2001, and on Russian stocks in Hungary since the end of 2001.<sup>4</sup>
- the CBR presents comparable data on Russian FDI flows into and stocks in Hungary since 2007 and the end of 2009, respectively.
- Rosstat circulates a limited selection of data.<sup>5</sup>

These statistical data sets show that

- (1) Russian FDI plays a limited role in Hungary, and Hungary is not an important destination for Russian FDI in Central and Eastern Europe. This provides a contrast to the fact that Russia is a key player among the countries with the highest share of Hungarian imports of goods on account of its shipments of oil and gas (it occupies a stable position in second or third place, depending on whether the principle applied is “country of origin” or “country of departure”); and
- (2) the statistical data mainly reflect the activities of two players, the Rakhimkulov family (i.e. Megdet Rakhimkulov and his sons, Ruslan Rakhimkulov and Timur Rakhimkulov) and of Surgutneftegaz, Russia’s third-largest oil producer.

According to the CBR, at the end of 2013 Hungary’s share in total Russian outward FDI stock was only 0.07 percent, putting Hungary in 11th place among the Central and East European countries, with only USD 316 million (Table 2; CBR, 2014). Only five CEE countries ranked behind Hungary.<sup>6</sup> At the end of both 2009 and 2010, a totally different situation was observed, as Russian FDI stocks in Hungary had surged. According to the CBR, Russian FDI stock in Hungary reached USD 2.3 billion and USD 2.2

<sup>3</sup> Also, in this paper, we will not provide an overview of Russian OFDI and MNEs. We have already done so in Kalotay et al. (2014).

<sup>4</sup> The MNB has started to publish data in line with the sixth edition of the IMF’s Balance of Payments and International Investment Position Manual (BPM6 methodology). The old methodology is called BPM5 (i.e. the fifth edition of the IMF’s Balance of Payments and International Investment Position Manual). See MNB (2014g, 2014h).

<sup>5</sup> Because of the limited availability of data, we will not deal with data from Rosstat here.

<sup>6</sup> The MNB, by contrast, recorded negative values of Russian FDI stock in Hungary at the end of 2013 (Tables 5 and 6; MNB, 2015d, 2015e). The value is negative because one of the three main components of FDI, intra-company loans, are in the negative range. The fact that a foreign affiliate acts as a net creditor of the parent company is a common financial measure by MNEs looking for optimizing their resources and taxes (Kalotay et al., 2014).

billion in 2009 and 2010, respectively.<sup>7</sup> These figures are connected to Surgutneftegaz's 21.2 percent stake in the Hungarian oil and gas company Mol. Acquired in 2009, and subsequently sold in 2011, this stake is considered the single largest item of Russian FDI in Hungary. The deal was highly significant for both countries.

From the Russian point of view, it presents evidence that even during the financial and economic crisis of 2008/2009, there were still very large Russian OFDIs registered:

- The Surgutneftegaz deal occupied the sixth and seventh places among the top outward merger and acquisition (M&A) transactions from Russia between 2007 and 2009 and between 2007 and 2010, respectively (Kuznetsov et al., 2011; Kuznetsov, 2011).
- CBR data shows that in 2009 Hungary was the seventh largest recipient of FDI flows from Russia (CBR, 2015b). At the end of both 2009 and 2010, in terms of the stock of Russian FDI, Hungary ranked first among the CEE countries, ahead of Bulgaria, Lithuania, the Czech Republic and Montenegro. Despite these regional rankings, however, stock data from the CBR suggests that at the end of 2009 and 2010, Hungary took only the 17th and 19th places among the most attractive Russian FDI destinations in the world, with respective shares of 0.75 and 0.61 percent (CBR, 2014).

Looking at this from the Hungarian perspective: Although in 2009 Russia was among the largest investors in Hungary (without special purpose entities or SPEs and using BPM5 methodology: in the category “equity capital” – first place; in “equity capital and reinvested earnings” – second place; in “equity capital, reinvested earnings and other capital” – third place) (MNB, 2014c<sup>8</sup>),<sup>9</sup> the one strong year did not have a major impact in terms of its low share in the overall FDI stock in Hungary: with a 1.6 percent share of total FDI stock, it was still only in 11th place in the ranking of countries with FDI in Hungary (also excluding SPEs and using BPM5 methodology) (MNB, 2014a<sup>10</sup>).<sup>11</sup> With the help of the MNB, we looked at what the Hungarian statistics really indicate.<sup>12</sup> Quarterly data reported by the MNB on Russian FDI in Hungary between 2001 and

<sup>7</sup> The MNB, by contrast, calculated lower figures regardless of whether it included SPEs or not, and regardless of whether it used BPM5 or BPM6 methodology (see the explanation below and the respective figures in Tables 4–6; MNB, 2014a, 2014b, 2015d, 2015e).

<sup>8</sup> For the figures according to the BPM6 methodology, see MNB (2015a, 2015b).

<sup>9</sup> Including SPEs, Russia was ranked fourth, fifth and fifth, respectively (BPM5 methodology, MNB, 2014d). For the figures according to the BPM6 methodology, see MNB (2015c).

<sup>10</sup> For the figures according to the BPM6 methodology, see MNB (2015e).

<sup>11</sup> If SPEs are included, Russia's share is even much smaller (0.6%) and even much further back (16th) in the ranking (BPM5 methodology, MNB, 2014b). For the figures according to the BPM6 methodology, see MNB (2015d).

<sup>12</sup> The following paragraphs are based on several personal communications with two anonymous MNB experts (these took place between March and May 2012).

2014<sup>13</sup> (only equity capital) clearly show that meaningful transactions only transpired in three quarters of three different years,<sup>14</sup> including (1) the second quarter of 2008 (EUR -677.4 million), (2) the second quarter of 2009 (EUR 789.7 million) and (3) the third quarter of 2011 (EUR -1,860.8 million). These numbers are the same with or without SPEs.

The data provided for these three quarters reflect only a single transaction in each of these quarters, including one relating to the Rakhimkulovs and two connected to Surgutneftegaz.

- The first transaction is connected to Kafijat Investment and Asset Management Zrt., which used to be Megdet Rakhimkulov’s large family business (see the details below in Section 3.1). The MNB informed us that according to the information found in the Complex Céghírek, a business registration database of companies in Hungary, from April 2008 onwards Kafijat had Cyprus-based owners. This change of ownership was recorded in the balance of payments. According to CompLex Céghírek, the ownership stakes of Megdet Rakhimkulov, Ruslan Rakhimkulov and Timur Rakhimkulov were discontinued on 30 April 2008, while on the same day the Cyprus-based AWB Consulting Services Ltd. and Charing Investments Ltd., i.e. the companies of the Rakhimkulov brothers, acquired Kafijat.<sup>15</sup> At the general meeting held on 30 April 2008, due to divestment, Kafijat’s share capital was reduced substantially, from HUF 98.45 billion to HUF 10.45 billion, with effect from 30 April 2008, and huge dividends were paid (Complex Céghírek; HVG, 2007, 2008a, 2008b). The capital reduction is linked to the investors from Cyprus.<sup>16; 17</sup>
- The second and the third balances are linked to the acquisition and sale of shares in Mol. But the figures that the MNB published for 2009 are far below the EUR 1.4 billion amount that was publicly disseminated. According to the MNB, the reason for this difference is that Mol was involved in the transaction as a third party (i.e. Mol’s shares were acquired and then sold, and the company itself was neither a buyer nor

<sup>13</sup> Quarterly data for the years between 2001 and 2013 were produced according to the BPM5 methodology. The MNB published quarterly data according to the BPM6 methodology only for 2014. For quarterly data, see Tables 8 and 9 (BPM5 methodology: MNB, 2014e, 2014f; BPM6 methodology: MNB, 2015f, 2015g). For annual data, see Tables 11–13 (BPM5 methodology: MNB, 2014c, 2014d; BPM6 methodology: MNB, 2015a, 2015b, 2015c).

<sup>14</sup> As Table 9 indicates, a relatively large amount of Russian FDI was received in the last quarter of 2014. However, if we do not only exclude SPS but also capital in transit and the restructuring of asset portfolios, then this amount will be much lower. Capital in transit means that Hungarian companies receive capital or a loan from one member of a group of companies, which they transfer to another foreign member of the group at very short notice. Capital in transit distorts the economic interpretation of data on foreign direct investment (MNB, 2011). The restructuring of multinational companies’ asset portfolios (financial restructuring) may also sharply increase the FDI inflow and outflow data of a given period without any foreign funds entering the country in net terms (MNB, 2013).

<sup>15</sup> In 2014, Ruslan Rakhimkulov and Timur Rakhimkulov became Kafijat’s direct owners. AWB Consulting Services Ltd. and Charing Investments Ltd. are now Kafijat’s subsidiaries.

<sup>16</sup> Source: personal communication with the MNB (9 March 2012).

<sup>17</sup> The ownership change was announced and recorded in April 2008, while the capital reduction was registered in July 2008 (eBeszámoló).



a seller), so the acquisition transaction was not accounted on the basis of the value that was reported in the press, but was instead calculated on the basis of the stock price multiplier (note that Surgutneftegaz paid double the market price) because “Mol as the data provider was not aware of the figure that appeared in the press”.<sup>18</sup>

The flow data for 2007 (Tables 11–13; MNB, 2014c, 2014d, 2015a, 2015b, 2015c) does not tell us why the stock figures (Tables 4–6; MNB, 2014a, 2014b, 2015d, 2015e) increased dramatically from the end of 2006 (amounting to EUR 17.1 million without SPEs and to EUR 19.4 million with SPEs) through the end of 2007 (amounting to EUR 697.3 million without SPEs and to EUR 699.8 million with SPEs).<sup>19</sup> The MNB said that the increase in the stock of Russian FDI was linked to Kafijat and its owner, who had changed his residency status during that year: Megdet Rakhimkulov, who had been a Hungarian investor, turned into a Russian investor (in other words, he moved back to Russia in 2007), thus the Russian FDI stock increased without any transactions.<sup>20; 21</sup>

These data, however, do not capture the whole picture about Russian FDI in Hungary. The main problem is that in many cases investments are routed through a third country (indirect FDI, trans-shipment). One does not necessarily need to think of this third-country company as a special purpose entity (including/or a holding company; see Dippelsman, 2004), which can be either offshore or not, with the corresponding taxation, regulatory and confidentiality benefits (Tavakoli, 2003; IMF 2004). It has happened, for example, that a foreign manufacturing company with a Hungarian subsidiary was taken over by Russian owners (specifically, Austria’s Vogel & Noot, which also has subsidiaries in Hungary, among other countries, was sold to the Russians, see Section 3.7).

Furthermore, there are two other problems that must be addressed when executing searches in the Hungarian company registration database on companies with Russian owners. First, “cascading investments” (i.e. “multi-layered structures”)<sup>22</sup> may hide the nationality of the ultimate owners. This refers to companies that are set up or acquired in Hungary by Russian interests but are registered as Hungarian companies. The second problem is that joint-stock companies (“rt.” in Hungarian) are not required to disclose their ownership structure in Hungary.<sup>23</sup> There is information about share ownership in the documents kept by the courts of registry and in the companies’ financial statements, but not every joint-stock company discloses this information in the register of companies.

<sup>18</sup> Source: personal communication with the MNB (9 March 2012).

<sup>19</sup> The figures are the same using either BPM5 or BPM6 methodology.

<sup>20</sup> Source: personal communication with the MNB (9 March 2012).

<sup>21</sup> At the end of 2007, Megdet Rakhimkulov was a 98.3 percent owner, while Timur Rakhimkulov and Ruslan Rakhimkulov held 0.85 percent each. According to official statements dated 18 September 2006 and 25 May 2007, Megdet Rakhimkulov’s share amounted to 71.44 percent, while Timur Rakhimkulov and Ruslan Rakhimkulov had a share of 14.28 percent each.

<sup>22</sup> These expressions are used by Indian sources.

<sup>23</sup> Opten, a company information service provider, helped to interpret the data (personal communications, April 2012).

In 2015, 118 companies in the MNB's registry were noted as having Russian FDI stock (compared to 103 in 2012).<sup>24</sup> But the small and thus omitted items do not substantially distort the numbers.

Citing unnamed Russian sources – but essentially just reiterating information that had already been circulated by its predecessor, ITD Hungary –, the Hungarian Investment and Trade Agency (HITA) claimed that over 2,000 joint ventures with Russian ownership were operating in Hungary.<sup>25</sup> The Russian trade representation in Hungary also has information about some 2,000 companies with Russian shareholders, mainly small and medium-sized enterprises (Hancz, 2012; Hvg.hu, 2012).<sup>26</sup> We cannot provide more accurate data because of indirect FDI, “cascading investments” and problems related to the disclosure of ownership of joint-stock companies.<sup>27</sup>

In his presentations delivered in both October 2009 and February 2010, György Gilyán, then Hungary's ambassador to Russia, said Russian direct investment capital had mainly preferred the real estate, commercial, financial, energy and infrastructure-related industries in Hungary (Gilyán, 2009, 2010).

### 3. Case studies of Russian investment

#### 3.1. *The Rakhimkulov family*

Since he has played a significant role in Hungary right from the start – both as a top Russian investor on his own account and as a representative of Gazprom-related interests –, Megdet Rakhimkulov, a former Gazprom official, is undoubtedly an ideal starting point for tracing Russian investors and investment in Hungary. Though he was listed as Hungary's richest businessman in 2005 by the Hungarian daily *Népszabadság*, Rakhimkulov's fortune was insufficient to secure such a prominent place in Russia, let alone worldwide. Nevertheless, the total wealth of the Rakhimkulov family can be considered very significant.<sup>28</sup> Also, Megdet Rakhimkulov was recognised as one of the most influential foreigners in Hungary (Haszon, 2008). He used to say that the yardstick

<sup>24</sup> 118 companies submit reports to the MNB. Source: personal communication with the MNB (12 June 2015).

<sup>25</sup> The particular websites are no longer available. HITA's legal successor is the Hungarian Investment Promotion Agency (HIPA) established in 2014.

<sup>26</sup> In this regard, Gábor Reppa, a Hungarian expert, told the author that it was almost certain that there were no Russian statistical databases that kept track of the international operations of companies with Russian ownership stakes because according to Russian law it is not obligatory for Russians to notify an authority when a company was set up abroad. The number of Russian-interest companies operating in Hungary can be calculated by using the Complex Céghírek company registration database of businesses in Hungary. Official state documents also rely on this database, and HITA and the Trade Representation of Russia (via HITA) are using these state documents (personal communication, 5 June 2013).

<sup>27</sup> Though, Opten, for example, has a more sophisticated database.

<sup>28</sup> Based on the lists of the Russian *Finans* and the American *Forbes* magazines.

whereby he decided that his investment had been a success and it was time to withdraw was the point where the company reached a 50 percent profit margin.

The General Banking and Trust (ÁÉB) was a crown jewel among the Rakhimkulov family assets. ÁÉB was acquired in 1996 by Gazprombank (then controlled by the gas giant Gazprom<sup>29</sup>), and was gradually taken over by the Rakhimkulovs' family company, the Hungarian-registered Kafijat, and its London-based subsidiary, Firthlion Ltd.<sup>30</sup> Megdet Rakhimkulov became ÁÉB's president in 1996, and then the company's president and CEO in 1997.

Incorporated in 1997, Kafijat was used to acquire direct or indirect stakes in Hungarian companies. A number of companies merged into Kafijat, and, finally, at the end of 2007, so did ÁÉB<sup>31</sup> (see the details in Section 3.5). The significance of Kafijat was highlighted by the fact that in 2008 the company had amassed the sixth largest net income (after-tax profit) among Hungarian-registered companies (HVG, 2010).

ÁÉB and other Russian-interest companies also held stakes in Zalakerámia, Hungary's largest tile manufacturer; this investment was tainted by scandals.<sup>32</sup> However, the major scandals took place surrounding the deals concerning Hungary's petrochemical manufacturers BorsodChem and TVK, as well as the aforementioned oil and gas corporation Mol (see the details in Section 3.3). Megdet Rakhimkulov appeared in every case. Moreover, in the mid-2000s, the Rakhimkulov family was reported as the largest shareholder in BorsodChem. The Rakhimkulov family also held stakes in Antenna Hungária Rt., Hungary's terrestrial broadcaster, and still owns the largest share in Hungary's leading retail bank, OTP Bank Nyrt., with a roughly 9 percent stake. In 2002, Megdet Rakhimkulov resigned from the position of the chairman of the board of directors of Panrusgáz (then Panrusgáz Hungarian–Russian Gas Industry Rt., now Panrusgáz Gas Trading Zrt.), an intermediary company for Russian gas imports delivered to the successor of Hungarian gas incumbent E.ON Natural Gas Trade Zrt., Hungarian Gas Trade Zrt., a subsidiary of Hungary's state-owned MVM Hungarian Electricity Zrt. Timur Rakhimkulov, a minority shareholder, was intended to be the majority owner of Business Telecom Nyrt., or BTel, a Hungarian telecom provider, via his Hungarian-registered company SkillInvest Kft. BTel is in a very difficult position. Previously, SkillInvest had been identified as BTel's saviour, but ultimately it emerged that it would not perform a capital increase of nearly HUF 1 billion, claiming at the end of 2014 that

<sup>29</sup> Gazprom has not had control over Gazprombank for many years. Gazprom currently has a 35.54 percent stake in the company (Gazprom, n.a.).

<sup>30</sup> Sources suggest Firthlion is now owned in equal parts by AWB Consulting Services Ltd. and Charing Investments Ltd. (Check Business, n.a.; DueDil, n.a.). (See these two companies above in Section 2.)

<sup>31</sup> At that time ÁÉB was called ÁÉB Investment Zrt. and Kafijat was operating under the name Kafijat Investment and Asset Management Zrt.

<sup>32</sup> At the end of 2004, Megdet Rakhimkulov pointed out that in the previous 5-6 years they had only acquired Zalakerámia, and they were only present as financial investors in other companies. Rakhimkulov claimed that the unprofitable Zalakerámia had begun to yield profits within a year (Figyelő, 2004).

not all the necessary information had been available. This is the latest scandal to hit the Rakhimkulovs. The Rakhimkulov family has faced several scandals concerning their activities in Hungary.

### 3.2. *Gas*

Although a new gas market situation – as evidenced by gas oversupply, the emerging role of market-based gas pricing and the possibility of buying gas more cheaply than provided by the oil product-linked contracts<sup>33</sup> – began to unfold in Continental Europe at the end of 2008, Russian gas still has a decisive role in Hungary’s gas industry, and Russia remains the single largest gas supplier to Hungary. On the other hand, Hungary is among the Gazprom group’s largest customers in the CEE region. Yet despite the significance of Russian gas in Hungary’s gas imports, as well as plans to expand into Hungary, state-controlled Gazprom still plays a limited role as an investor, and the issue of the unbundling of transmission assets under the Third Energy Package for an internal gas and electricity market in the EU further limits its abilities. Both in the case of the oil and gas industries in Hungary, Russian oil and gas companies found themselves unable to control the entire value chain from wellhead to final customer. Gazprom’s main ownership interest in Hungary is Panrusgáz. In addition, Gazprom also has stakes in two gas traders. The other plans and projects have all failed.

#### 3.2.1. *Gas import intermediation*

Established in 1994, Panrusgáz is the first link in the chain of Russian gas imports. Panrusgáz sells all the gas it imports to Hungarian Gas Trade. The Russian shareholders of Panrusgáz are Gazprom Export, a company fully owned by Gazprom which serves as its export arm (it owns 40 percent of the shares), and the Hungarian-registered gas trader Centrex Hungary Zrt. (which holds 10 percent of Panrusgáz shares). Centrex Hungary is an affiliate of the Gazprombank-controlled and Vienna-based Centrex Europe Energy & Gas AG. Centrex Hungary bought Interprokom’s 10 percent stake in Panrusgáz in the autumn of 2006 (Világgazdaság, 2006). Currently, Gazprom Export has two long-term gas supply contracts with Hungary, including the major one with Hungarian Gas Trade through Panrusgáz (signed in 1996 for the period 1996–2015<sup>34</sup>), and a small contract with Centrex Hungary (concluded in 2007 for the period 2008–2028). Originally, it was intended that Panrusgáz would also help with the exports of Hungarian products to Russia. Panrusgáz was forced to pay the Hungarian state significant amounts in the form of a “crisis tax”<sup>35</sup>, prompting the company in December 2010 to ask the Hungarian energy regulator to revoke its gas trading licence, which the Hungarian Energy Office did in February 2011. Consequently, the Hungarian partner (first E.ON

<sup>33</sup> Due to declining oil prices, however, Russian oil product-linked gas prices could become very competitive in the second half of 2015. (Transportation costs should also be considered when comparing hub prices with Russian oil product-linked gas prices at a given delivery point.)

<sup>34</sup> No new long-term gas supply contract will be signed for a while, because unused gas will be available in the following years.

<sup>35</sup> The crisis taxes were introduced in 2010 and were phased out at the end of 2012.

Natural Gas Trade and then, between September 2011 and June 2013, Germany's E.ON Ruhrgas AG, and now E.ON Natural Gas Trade's successor, Hungarian Gas Trade) has been taking the gas abroad from Panrusgáz, with new delivery points, including Baumgarten (Austria) and Beregovo (Ukraine) (B. Horváth, 2011; Magyar Energetikai Hivatal, 2011).

### 3.2.2. *Gas traders*

Among Hungarian gas traders, three have Russian owners and, as previously mentioned, Gazprom has stakes in two of these three.

1. One of them is the above-mentioned Centrex Hungary, which was incorporated in 2004.
2. Established in 2010, the second company is the Russo–German WIEE Hungary Kft., which received a gas trading license in Hungary in February 2011. Its ultimate owners are Gazprom and the BASF Group's Wintershall of Germany.<sup>36</sup>
3. MET Hungary Zrt. is a third trader, an obscure company that generates huge amounts of cash and is partially owned by Russian interests. MET Hungary (formerly Mol Energy Trade Kft. and then Mol Energy Trade Zrt.) was set up in 2007 by Mol, and became half-owned by the Belize-based Normeston Trading Ltd. in late 2009. In 2012, Normeston's stake was sold to RP Explorer Liquid Fund Ltd., a company registered in the Cayman Islands. The only information that has so far been released is that Normeston is or was owned by a Russian national (European Commission, 2009). The Hungarian watchdog NGO Atlatszo.hu speculated that Rakhimkulov was behind Normeston (Sarkadi Nagy, 2013). After much speculation, it turned out in early 2015 that the current Russian owner of MET Hungary is Ilya Trubnikov, a Russian–Canadian citizen, with a 12.7 percent stake (Magyari, 2015).

A recent Russian plan was to invest in liquefied natural gas (LNG) and compressed natural gas (CNG) filling stations in Hungary.<sup>37</sup> In October 2014, Gazprom Export said that its first filling station could open in 2015 or 2016. In Hungary, this market is very small, and it offers minor opportunities at best (B. Horváth, 2014).

### 3.2.3. *Gas pipeline, storage and hub: A list of unsuccessful projects*

Gazprom's other plans and projects in Hungary involve failures. After the failures of the BorsodChem and TVK transactions, Gazprom obtained no interest in Mol's gas business, and neither underground gas storages nor gas pipelines have been built.<sup>38</sup>

It seemed that after the partial sale of Mol's gas business, Gazprom would be able to acquire positions in Hungary. In the middle of the 2000s, E.ON Ruhrgas acquired the

<sup>36</sup> The owner of WIEE Hungary is the Swiss-registered Wintershall Erdgas Handelshaus Zug AG (WIEE), a subsidiary of the German gas trader Wintershall Erdgas Handelshaus GmbH & Co. KG (WIEH). WIEH is the joint venture of Gazprom and Wintershall.

<sup>37</sup> CNG is primarily used by passenger cars, while LNG is good for trucks and other large vehicles.

<sup>38</sup> However, there were pipeline plans already in the 1990s.

wholesale, marketing and trading unit Mol Natural Gas Supply Rt. (subsequently renamed E.ON Natural Gas Trade), the storage unit Mol Natural Gas Storage Rt. (subsequently renamed E.ON Natural Gas Storage) and half of Panrusgáz. Under the 2006 swap agreement between E.ON and Gazprom, Gazprom was to receive 50 percent minus one vote in both E.ON Natural Gas Storage and E.ON Natural Gas Trade, as well as 25 percent plus one vote in the electricity provider E.ON Hungaria Energy Zrt. (and, in addition to these, it was also due to receive EUR 1.2 billion) in exchange for a 25 percent minus one vote in the Yuzhno-Russkoye field located in Western Siberia. Ultimately, the deal was concluded without involving Hungarian ownership.

In Hungary's gas industry, Hungarian state-owned power company MVM has become established as the main player in no time. By purchasing E.ON Natural Gas Storage and E.ON Natural Gas Trade, MVM has emerged both as the largest gas trader and commercial gas storage company. Also, MVM had previously gained a foothold in Hungary's gas transmission<sup>39</sup> and took E.ON's place in Panrusgáz.

Gazprom's joint projects with Mol in Hungary did not turn out to be fruitful. Their two joint ventures, SEP Company Consulting Kft. and Pusztaföldvár Gas Storage Zrt., went into voluntary liquidation and were deleted from the registry in 2014 and 2012, respectively.

In 2006, Mol and Gazprom set up the SEP Company to examine the possibilities of extending the trans-Black Sea Blue Stream gas pipeline (running from Russia to Turkey), as well as the construction of underground gas storage facilities and the creation of a gas trading hub in Hungary, but none of the ideas were implemented.

As for the trans-Black Sea gas pipeline, in early 2008 an intergovernmental agreement was signed between Hungary and Russia for the Hungarian section of South Stream, though not for the corresponding section of Blue Stream.<sup>40</sup> Moreover, instead of Mol, the Hungarian state-run Hungarian Development Bank (MFB) Zrt. was selected as the Hungarian partner in the venture. But the joint venture (South Stream Hungary Zrt.) was only registered in March 2010. MVM bought up MFB's stake in 2012.<sup>41</sup> The European onshore sections of South Stream were subject to the Third Gas Directive, so the problems of third-party access, transportation tariffs and unbundling should have been resolved. It has been known since the very beginning that the intergovernmental agreements on South Stream will not comply with the Third Gas Directive. And the

<sup>39</sup> This new transmission system operator (TSO) is called Hungarian Gas Transit Zrt. In the autumn of 2014, the stakes held by MVM Hungarian Electricity Zrt. (49.983%) and MFB Invest Zrt. (49.983%) were acquired by Hungarian National Asset Management (MNV) Zrt. Hungary's interior ministry was appointed to exercise ownership rights on behalf of the state until 2020.

<sup>40</sup> South Stream was planned to come ashore on the Bulgarian coast and would thus have avoided both Ukraine and Turkey.

<sup>41</sup> However, SEP Company had some role in South Stream's preliminary studies.

European onshore sections did not apply to the respective national energy regulators for exemptions from the above provisions of the Directive.<sup>42</sup> The European Commission required the concerned South Stream countries to either renegotiate or cancel their intergovernmental agreements.<sup>43</sup> Finally, Russia unexpectedly abandoned the South Stream project on 1 December 2014. In place of South Stream, Russia has proposed to build an undersea pipeline to Turkey (which is neither an EU member nor an Energy Community Contracting Party), with the same capacity as South Stream (dubbed Turkish Stream by Turkey).

Regarding the joint project of Mol and Gazprom to construct an underground gas storage facility, after the abandonment of the project the joint venture Pusztaföldvár Gas Storage, which had originally been registered in early 2010, was placed under voluntary liquidation in October 2011. According to the Hungarian economic daily *Világgazdaság*, Mol revised its cost estimates for the project, and as they exceeded the original figures by an order of two, the new numbers proved too high (*Világgazdaság*, 2011b). In March 2009, at the time when the contract to set up the joint venture was signed, Mol had planned to construct a facility with a capacity of 1.3 billion cubic meters, which was expected to start operating around 2012-2013 (Mol, 2009). E.ON Natural Gas Storage claimed that measured by its gas consumption, Hungary was a great power in terms of gas storage, and the total gas storage capacity demonstrated that there was no need for further expansion (*gáz.áram*, 2011). It is fairly common for Gazprom to offer its partners a storage project.

In 2014, there were reports in the media that the Hungarian government planned to sell gas storage facilities to Gazprom, but the government denied this assertion (Kósa, 2014). After President Putin's visit to Hungary at the beginning of 2015, the Hungarian Prime Minister said that Hungary had expected Putin to ask for a stake in the Hungarian gas storage facilities, but ultimately Putin had not done so. In any case, no ownership stakes would have been made available for sale (Hvg.hu, 2015b).

Already in the 1990s Gazprom had been present, albeit indirectly, in Hungary's regional gas distribution. Milford Holdings Ltd., a company registered in Ireland, held a 19.91 percent stake in South Lowlands Gas Distribution (Dégáz) Rt., while Undall International Ltd., registered in the British Virgin Islands, acquired a 12.93 percent stake in North-Transdanubian Gas Distribution (Égáz) Rt. Both foreign investing companies were considered to belong to Gazprom's sphere of interest. Ultimately, these shares probably ended up with Mol. Subsequently, Milford became known for its role in the hostile takeover attempt of BorsodChem (Fn24, 1997; Napi Gazdaság, 2000; Origó, 2000b; Magyar Hírlap, 2000c).

<sup>42</sup> According to Article 36(6) of 2009/73/EC, major new gas infrastructure may be exempted from these provisions.

<sup>43</sup> An interview with Katya Yafimava by RT (RT, 2014a).

### 3.3. Petrochemical market

Since 2003, Gazprom has no stake in either BorsodChem or TVK, despite its previous plans and acquisitions in this area, i.e. the controversial hostile takeovers of 2000–2002, which featured the use of Milford and Sibur International Ltd. and also involved the help of Megdet Rakhimkulov.

The supply chain that links TVK, Mol and BorsodChem is as follows. TVK's olefin plants convert naphtha, diesel and liquefied gases purchased from Mol into ethylene and propylene to be processed into polyethylene and polypropylene in TVK's polymer plants. A part of TVK's ethylene is sold to BorsodChem. The cracking co-products of TVK's olefin plants are used by Mol (TVK, 2014). TVK owns the ethylene pipeline connecting TVK and the Hungary/Ukraine border (which originates from the Ukrainian chemicals producer Oriana), while the link between TVK and BorsodChem is owned by BorsodChem (GVH, 2001).

The takeover story began in early September 2000, when it turned out that Milford had increased its stake in BorsodChem to 24.8 percent. Although Milford's ownership structure was not disclosed, market players were all aware that Milford had been acting on behalf of Gazprom. Gazprom, however, strongly denied this assumption (Magyar Hírlap, 2000c; Magyar Tőkepiac, 2000). At that time, BorsodChem was TVK's largest shareholder. By acquiring BorsodChem, Gazprom would have controlled both companies. This would have been contrary to the interests of Mol (Magyar Hírlap, 2000b). Consequently, Mol and BorsodChem responded immediately and, through a variety of transactions, Mol became the largest shareholder of TVK, and as a result, BorsodChem's share in TVK fell by half. Before the official announcement of these transactions, Milford admitted that the company was part of Gazprom's sphere of interest (Magyar Hírlap, 2000d). The Russian side reacted menacingly to the planned Hungarian actions. Megdet Rakhimkulov, Milford's representative, suggested Russia would be forced to reconsider its food and drug imports from Hungary if the issue was not resolved (Karnitschnig, 2000). Rakhimkulov claimed that the ethylene pipeline had been one of the main reasons Gazprom become involved in BorsodChem, noting that the goal was the "creation of a pan-European ethylene pipeline that would include Russia, Ukraine, Hungary and some other European countries" (The Moscow Times, 2000). But in October 2000, it was not Gazprom but Lukoil that won a tender to purchase a 50 percent stake in Oriana (Jagger, 2000). In December 2000, Lukoil and Oriana established a joint venture, Lukor (Gurtovoy, 2007). Still, in October 2000, Sibur took an option to purchase Milford's stake. Reportedly, Gazprom already controlled Sibur, but Sibur was not a Gazprom subsidiary (Magyar Hírlap, 2000a). It was only later that Gazprom acquired a 51 percent control of Sibur's shares. In early 2001, Milford's stake was bought by Hungary's CIB Bank. Founded by Heinrich Pecina and registered in Vienna, VCP Vienna Capital Partners Unternehmensberatungs AG and its subsidiaries also appeared on the scene. VCP stressed that it had no direct or indirect ownership links to Russian companies (Molnár, 2000). VCP acquired a controlling stake in BorsodChem already



in 2001, but Mol prevented the Austrian company from achieving such a position in TVK. In June 2001, Sibur took over the shares that had been temporarily held by CIB Bank (GVH, 2001). In 2002, it was again Milford's turn to take ownership of that package, but, finally, Milford unloaded its stake in BorsodChem in 2003. For a while, MDM Bank in Moscow was also one of the owners of BorsodChem. According to MDM Bank, it bought the shares at the request of Gazprom, and so did VCP (Origó, 2000a; Novolodskaya, 2000). Sibur and hence Gazprom as well were more interested in the acquisition of TVK than in buying BorsodChem. In and of itself, BorsodChem was not that interesting for Gazprom (Hlavay, 2001). In the end, VCP stopped controlling BorsodChem in 2004. The Rakhimkulov family got out of BorsodChem in December 2006.<sup>44</sup> However, the story of TVK ended only in 2007, when Mol acquired a package of 31.56 percent of the company's shares from a subsidiary of VCP.

### 3.4. Oil

Investment in Hungary's oil industry has also included plenty of failed efforts, including those of Yukos, Surgutneftegaz, Lukoil and Gazprom Neft.

*Yukos.* Unlike the oil company Lukoil, the now defunct Russian oil producer Yukos did not have a retail business in Hungary. Yukos was present in Hungary through its representation and Orion Electronics Kft., a company engaged in business activities outside of Yukos' core activities. Before the company was destroyed and its assets were appropriated, Yukos, a private company, was the most important oil producer in Russia in 2003 (Shearman & Sterling, 2014). Its main production unit was Yuganskneftegaz. In 2003, Mol concluded a major long-term oil supply contract with Yukos. Thus the Yukos situation directly affected Mol, which signed a contract with Lukoil in early 2005. Yukos' representation for the Central and East European region was located in Budapest. Yukos was actively promoting the integration of the Druzhba and Adria crude oil pipelines. The name Yuganskneftegaz did not first come up during the confiscation of Yukos' assets in the 2000s. For a little while after its privatization (from 1992 to 1993), today's Orion Electronics, which provides electronics manufacturing and marketing and distribution services, was called Yuganskneftegaz Electronics Kft., and, from 1993 to 1997, it was operating under the name of Yuganskorionneftegaz Electronics Kft. The company has been under Singaporean control since 1997. In Orion Electronics, Yukos was replaced by Rosneft, which absorbed most of Yukos' assets and thus became Russia's largest oil producer, the state oil champion.

*Lukoil.* Lukoil, Russia's second-largest oil producer (and the largest privately-owned oil producer), began to be active in Hungary at the turn of 2003/2004. It already had a Hungarian presence before that time, however, through its trade representation and

<sup>44</sup> In April 2007, Hungary's financial-market regulator PSZÁF fined Megdet Rakhimkulov HUF 250 million for insider trading concerning the July 2006 call option agreement regarding BorsodChem shares.

Stavrochem Chemical Trading Kft., a wholesaler of chemical products. Lukoil became involved in the Hungarian motor fuels retail and wholesale market in 2004. Its Hungarian subsidiary, Lukoil Downstream Hungary Kft., launched its activities in the area of diesel fuels wholesale in March 2004. This was followed by entry into the fuel retail market in June 2004, where the company began its activities by leasing and operating 15 Hungarian filling stations of AVA Mineralölhandel AG (formerly Avanti) (GVH, 2005).<sup>44</sup> Lukoil's network of filling stations was built by acquiring independently operated, Avanti and Jet filling stations (the latter had belonged to the US company ConocoPhillips), as well as by greenfield investment. But Lukoil's ambitious expansion plans in Hungary failed to materialize. Before selling its filling stations at the end of 2014, Lukoil, through its Dutch-based subsidiary, had a network of only 75 filling stations in Hungary – a small figure when compared to the total of almost 1,700 filling stations operating in Hungary. Lukoil ranked sixth in terms of the numbers of filling stations, behind Mol, Shell, Agip, OMV and Avia (Major, 2013). According to data from Lukoil, the company controlled 6 percent of the retail market in Hungary in 2013 (Lukoil, 2013, 2014). Examining the Hungarian retail gasoline market for the period 2007–2008, Farkas et al. (2009) found that the prices of the vertically integrated Lukoil had been among the lowest in Hungary, and Lukoil may potentially have been the greatest source of competitive pressure on the market. Meanwhile, vertically integrated Mol and OMV were selling fuel at higher-than-average prices. The motor fuels sold by Lukoil Hungary Kft. were supplied both from Hungary's Mol Duna Refinery and Romania's Petrotel-Lukoil Refinery (Világgazdaság, 2011a).<sup>46</sup> Due to the “crisis tax” in Hungary, Lukoil Hungary returned its wholesale fuel licence in 2010 (Marnitz, 2010), but returned to the market at a later point in time (B. Horváth, 2013). In 2014, Lukoil decided to withdraw from the Central European region. Lukoil argues the selling off its European assets helps the company better focus on Russian projects (RT, 2014b). But analysts believe the EU and US sanctions have certainly contributed to this decision. Such assessments notwithstanding, among the Russian oil and gas companies that have been operating in Hungary thus far, the sanctions imposed by the EU only affect Gazprom Neft. In the meanwhile, US sanctions hit Gazprom, Gazprom Neft, Lukoil and Surgutneftegaz as well (U.S. Department of the Treasury, 2014a, 2014b; Council Regulation, 2014a, 2014b). Lukoil's Hungarian and Slovakian filling stations were acquired by Norm Benzinkút Kft., which is registered in Hungary but also has some connections to Russia.<sup>47</sup>

<sup>45</sup> Lukoil Hungary Kft. was established after Nekom Commercial Kft. merged into Lukoil Downstream Hungary Kft. in 2005. Nekom was established by AVA AG in 2004 in order to sell its filling stations.

<sup>46</sup> Fuels from the Romanian refinery comply with the Euro 5 standards (Lukoil, 2011). However, a Hungarian expert told this author that even at their peak, the amounts arriving from Romania were minor (personal communication, 14 May 2015).

<sup>47</sup> It is a joint venture between IMFA Petroleum Kft. (created by a former Hungarian representative of Yukos) and the above-mentioned Belize-based Normeston.

*Surgutneftegaz*. Surgutneftegaz's stake in Mol was bought from Austria's OMV oil company, which had been stuck with its share package acquired in 2007. A portion of the Mol shares held by OMV came from the Rakhimkulov family. The Rakhimkulov family sold a part of their stakes in Mol to VCP, the company which had an important role in transactions involving BorsodChem and TVK. VCP in turn passed the shares to OMV. In October 2007, shortly after the Rakhimkulov–VCP–OMV transactions, the Hungarian parliament approved the 'Lex-Mol' legislation, aimed at preventing a hostile takeover bid.<sup>48</sup> Finally, in March 2009, OMV's stake in Mol was sold to Surgutneftegaz for EUR 1.4 billion (USD 1.8 billion), double the market price.<sup>49</sup> With its 21.2 percent stake, Surgutneftegaz emerged as the largest shareholder in Mol. The fact that Surgutneftegaz picked Mol as the target of its first OFDI is also interesting. The purpose of the acquisition was unclear, and the ownership structure of Surgutneftegaz has not been made public either. Mol chairman and CEO Zsolt Hernádi did not describe the transaction as a hostile takeover (in contrast to OMV's action), but the Russian company was only considered a financial investor (HVG.hu, 2009a), and Mol did everything possible to keep Surgutneftegaz away from exercising its ownership rights,<sup>50</sup> prompting the latter to resell its stake to the Hungarian state. The agreement between the Hungarian state and Surgutneftegaz to buy back the stake in Mol triggered speculation whether the transaction was part of a package deal between the Russian and Hungarian governments.<sup>51</sup> Now, it appears that this was not the case.

Due to the failure of Surgutneftegaz, there are no Russian companies with shareholdings in the Visegrád countries' refinery industry. In Central and Eastern Europe, three Russian companies have oil refineries, including those of Lukoil (in Romania and Bulgaria), Zarubezhneft (in Bosnia's Serb-dominated Republika Srpska) and Gazprom Neft (in Serbia).

<sup>48</sup> Lajos Bokros, Hungary's former finance minister, claimed that that was a brutal attempt by the state to protect private interests. His remarks were aimed at Hungary's business oligarchs and the politicians who receive political donations from such oligarchs (Wagstyl and Thomas, 2007).

<sup>49</sup> Those who argue that Surgutneftegaz paid twice the market price for Mol's shares tend to forget that at that time the company's share price was very low.

<sup>50</sup> Consequently, Surgutneftegaz launched five lawsuits against Mol (Mol, 2011, p. 157).

<sup>51</sup> This allegation was supported by the fact that the sale of shares in Mol can be treated as a special case. A similar, but not identical, case occurred only in the context of the Slovak gas transporter SPP. The cases of TVK and BorsodChem in Hungary belonged to a different category. In the case of SPP, Gazprom did not exercise its option to buy a stake in SPP, and decided to build a bypass pipeline linking Russia and Germany under the Baltic Sea. Back then, this was known as the North European Gas Pipeline (NEGP), but now it is known as Nord Stream (IEA, 2006, p. 148). Nord Stream Lines 1 and 2 began operating in November 2011 and October 2012, respectively. The case of Yukos was also different. Acquired in 2002, the main foreign assets of Yukos were the shareholdings in Lithuania's Mazeikiu Nafta AB oil company and Slovakia's oil transporter Transpetrol. The purchase of the 53.7 percent interest in Mazeikiu Nafta was executed by Yukos in two steps for a total of USD 160 million. Subsequently, Yukos' stake was purchased in 2006 by Poland's PKN Orlen oil company for USD 1.492 billion from the Dutch-registered Yukos International UK B.V. As for Transpetrol, during a privatisation process Yukos took over a 49 percent stake in the company for USD 74 million. In 2009, the Slovakian state bought it back for USD 240 million, also from Yukos International UK B.V.

*Gazprom Neft.* Natural-resource-seeking Russian FDI has also appeared in Hungary. Gazprom Neft, Gazprom's oil arm and Russia's fourth-largest crude producer, has an indirect presence in Hungary via Serbia's NIS oil company, the majority of which is owned by Gazprom Neft. NIS has taken part in part in exploration projects in Hungary with the Hungarian subsidiaries of Canada's Falcon Oil & Gas (TXM Oil and Gas Exploration Kft.) and Austria's Rohöl-Aufsuchungs Aktiengesellschaft or RAG (RAG Hungary Kft.). Registered in Hungary in 2011, NIS subsidiary Pannon Naftagas Kft. represents NIS' interests in Hungary (Gazprom Neft, 2013). In 2014, NIS bought half of RAG Kiha Kft., a subsidiary of RAG via RAG Hungary Kft., which owns an exploration licence. NIS and Falcon's project in exploring for unconventional gas in the Makó Trough has been unsuccessful. According to the Canadian company, NIS has not complied with the agreement (Ádám, 2015).

### 3.5. *Banking*

In Hungary, there have only been two Russian-owned banks, including, in the past, ÁÉB (which was first owned by Gazprombank and later by the Rakhimkulov family), and, now, the subsidiary of Sberbank. ÁÉB passed into Russian ownership through privatization in 1996, while Sberbank entered the Hungarian market as part of a regional acquisition in 2012. The Rakhimkulov family's stake in OTP Bank is also important to mention. Besides these, Russian bank have only been present in Hungary through representative offices.

*ÁÉB.* According to Megdet Rakhimkulov, at that time Gazprom identified Hungary and Mol as a strategic country and a strategic partner, respectively. Several large-scale international projects between Russia and Hungary were agreed upon at the governmental level. Gazprom thus purchased ÁÉB, which, as Rakhimkulov claimed, was practically teetering on the edge of bankruptcy. But in the end, thus Rakhimkulov, Gazprom's new management changed its investment strategy for Hungary and the region and ultimately lost its interest in ÁÉB (Figyelő, 2004). Gazprombank pulled out of ÁÉB in 2005, when Kafijat Trading and Consulting Kft. held a 74.48 percent stake in the bank. The remaining 25.52 percent stake was acquired by Kafijat's Firthlion Ltd. After that, commercial banking business was not pursued for long. In March 2007, it was decided that it would only provide investment services (Hvg.hu, 2007). But already in 2007, ÁÉB, which was already operating under the name ÁÉB Investment Zrt., merged into Kafijat (Origó, 2007). ÁÉB was the eighth largest bank in Hungary (New Europe, 2003). At the end of 2005, ÁÉB had a total of only 17 branches (in Budapest and other Hungarian cities) (Világgazdaság, 2005). Previously, about 70 percent of ÁÉB's operations had been devoted to Gazprom and Gazprombank. In 2004, this proportion accounted for only about 8-10 percent, but a large part of the operations were still linked to Russian clients. At that time, ÁÉB's most important Hungarian customers were BorsodChem Rt., Mol Rt., Matáv Rt. (now Magyar Telekom) and DKG-East Rt. (now OT Industries–DKG Machine Manufacturing Zrt.). Besides Gazprom and Gazprombank, significant Russian partners included the MDM Group, Zenit Bank and the Nikoil

financial group (currently Uralsib). ÁÉB served more than 30,000 clients, 70 percent of which were households, while 30 percent were corporate (Simon and Szép, 2004). ÁÉB branches were taken over by Hungarian Volksbank Zrt., which was a subsidiary of the Austrian Volksbank.

*Sberbank.* In 2012, Sberbank, which is Russia's largest lender and is controlled by the CBR, became the owner of Volksbank International AG (though the transaction did not include the Romanian subsidiary). With this deal, Sberbank expanded beyond the former Soviet Union. There is a trace of historical continuity apparent in the fact that some of these Hungarian branches were previously owned by ÁÉB. According to the press, Hungary's OTP Bank was also interested in acquiring the Volksbank company. Sberbank operates 43 branches in Hungary (including 16 in Budapest), but has not reached a share of 5 percent in most segments. The aim is to ensure that as a universal bank, Sberbank will have a market share of more than 5 percent in all important segments of Hungarian banking by 2018 (Palkó, 2014). Once again, this marks an area where an investment in a specific sector was driven by the desire to find new markets. The primary objective of Sberbank's Hungarian subsidiary, Sberbank Hungary Zrt., is to provide comprehensive services to Russian private and corporate clients, and to enhance trade between the Central and East European countries and the Commonwealth of Independent States (Sberbank, n.a.). However, the Hungarian subsidiary has not proved to be a successful investment for Sberbank. Though the company's losses diminished year after year, press reports suggest that Moscow leaders were not altogether satisfied with the prevailing state of affairs at the bank. Lawsuits related to loans denominated in foreign currencies have also caused significant losses resulting from measures taken by Sberbank Hungary's predecessor (Szakonyi, 2015). Currently, the Hungarian banking industry is facing legal obligations to issue loanholders refunds in the context of loans denominated in foreign currencies, which were very popular before the economic crisis, but have proved a burden since exchange rates have depreciated markedly.<sup>52</sup> In 2014, the media suggested that Sberbank would withdraw from Hungary, but the bank denied that allegation (Reidl, 2014). In February 2015, the media learned that the Hungarian government would buy Sberbank's Hungarian branches (Szakonyi, 2015). Also, in February 2015, a Czech newspaper said that Sberbank was preparing to sell its Slovak and Hungarian operations (Reuters, 2015).

*Representative offices of Russian banks.* There are currently two Russian banks that are operating representative offices in Hungary, including Baltiyskiy Bank (since 1994) and Vneshekonombank (State Corporation "Bank for Development and Foreign Economic Affairs" or VEB) (since 2001). Rossiyskiy Kredit Bank closed its representative office in 2008.

<sup>52</sup> Refund obligations concern unfair unilateral contract changes and exchange-rate margins (Gergely et al., 2014).

- In 1995, Baltiyskiy Bank was on the verge of buying the Hungarian–Israeli Leumi Credit Bank, but ultimately this transaction was never concluded (Magyar Hírlap, 1995). Baltiyskiy Bank was founded in St. Petersburg in 1989, and, as a result of a bailout, it has belonged to Russia’s largest private bank, Alfa Bank, since 2014.
- State-owned VEB will play a special role in Hungary. The extension of the nuclear power plant near Paks, located some 100 kilometres south of Budapest in Central Hungary, is not an FDI issue and is highly controversial. According to the intergovernmental agreement signed in January 2014, Russia’s Rosatom State Atomic Energy Corporation will expand the Hungarian power plant. According to the loan agreement of April 2014, the Russians will provide an intergovernmental loan of up to EUR 10 billion to Hungary for the design, construction and commission of the future fifth and sixth blocks. VEB will act as an agent for the Russian government.
- The privately-owned Rossiyskiy Kredit Bank had a representative office in Budapest between 1997 and 1999, and another in Győr, in the Western part of Hungary, between 1997 and 2008. Rossiyskiy Kredit Bank played a significant role in granting loans for the export of Hungarian Ikarus buses to Russia and in organizing syndicated loans.

Among the abovementioned Russian banks, Gazprombank, Sberbank and Vneshekonombank were targets of sanctions imposed by the EU and the US.

### 3.6. Metallurgy

There is a strong indirect Russian presence in Hungarian metallurgy. For a long time, there had been no Russian metallurgical interest in Hungary, which was once obsessed with the notion of being the country of iron and steel. In the 2000s, Russian metallurgical companies were paying considerable attention to acquisition opportunities in Hungary, but no results were reported.

- At the end of 2003, Russia’s Severstal steel and mining company lost the tender for the privatisation of Dunaferri Danube Ironworks Rt. in Dunaújváros (situated some 70 kilometres south from Budapest). Severstal was focusing on the American Rouge Steel Company, which was more important to the Russian company because acquiring American Rouge Steel allowed it to become a steel supplier for US auto industry multinationals (Fn24, 2003). The consortium of (1) Ukraine’s Industrial Union of Donbass (ISD), (2) Ukraine’s ISD-controlled Alchevsk Metallurgical Plant, (3) the Swiss Duferco International Trading Holding Ltd. and (4) the Liechtenstein-registered Kundax AG won the tender (Dunaferri, 2003), but, in fact, Dunaferri was first taken over by Kundax AG, a project company set up by ISD (and Alchevsk Metallurgical Plant) and Duferco to handle acquisitions. Subsequently, in 2007, the stake was eventually turned over to the Cyprus-based Steelhold Ltd. (GVH, 2004a, 2004b; Dunaferri, 2007).<sup>53</sup> The change occurred in late 2009, when Russian investors obtained a stake of 50 percent plus two shares in the metallurgical assets of ISD (Olearchyk,

<sup>53</sup> These transactions clearly show the limitations of official statistical recording.

2010; Rusmergers.com, 2010).<sup>54</sup> As a result of this deal, Russian investors ultimately became involved in the metallurgical industry in the cities of Dunaújváros and Diósgyőr (the latter is part of the Northern Hungarian city of Miskolc). Various media sources mention Russian Vneshekonombank as the largest owner of ISD and ISD Dunafer Danube Ironworks Zrt. (Dunafer magazin, 2013; Ábrahám, 2013).<sup>55</sup> But in the official documents VEB only notes that it has helped a number of Russian investors to purchase ISD and that it supports Russian investors that had purchased ISD in the past (VEB, 2013a, 2013b). A Ukrainian source said in 2012 that the owners were still unknown, and that top managers from VEB were only placed into leading positions at ISD and its subsidiaries in 2011 (Troshina, 2012). The Hungarian economic weekly HVG wrote in August 2014 that Steelhold's stake was transferred from Vneshekonombank to the 60 percent Russian state-owned VTB Bank (Csabai and Vitéz, 2014). Sanctions imposed by the EU and the US are affecting both Vneshekonombank and VTB Bank. Due to the permanent crisis of Hungarian iron and steel, ISD's engagement seems to carry high risks. It was announced in 2013 that as part of a cost optimisation program, ISD Dunafer was looking to cut staff by 1,500. Reacting to this news, the Hungarian government offered to buy ISD Dunafer from VEB, but the offer was refused. At the time of the takeover, ISD presumably needed Dunafer because of Hungary's rolling mill capacity and the access to the EU market. But the EU market has been losing its significance.<sup>56</sup>

- In Diósgyőr, there had been no production since December 2008. The metallurgy in Diósgyőr moved from one liquidation to another. Back in the 1980s, 16,000 people had been working at the plant, while in 1991 this figure fell to 11,000 and dropped to only 1,500 in 2002. When production ceased in spring 2004, 1,200 workplaces were made redundant (Origó, 2004). Despite expressing its interest in April 2004, Evraz, Russia's steel holding, did not want to acquire ownership of the respective company in Diósgyőr, which is called DAM Steel Rt. In 2004, DAM Steel's assets were transferred to Dunafer's beneficiary, Európahíd 2003 Kft., which had been established by Ukrainian and Hungarian individuals but belonged to Dunafer/ISD. Still, in 2004 Európahíd 2003 changed its name to DAM 2004 Kft. In 2006, DAM 2004 was taken over by a company (Reeferway Ltd.) listed in the British Virgin Islands, which is affiliated with ISD. However, in 2009 DAM 2004 was once again under liquidation. In 2010, the liquidator sold the assets of Diósgyőr metallurgy to Öko-Ferr Kft., which belongs to ISD Dunafer's ISD Power Kft. Several investors have expressed interest in DAM's assets since then, but none of these declarations of interests has progressed into the contract preparation phase (Leszák, 2012).
- Mechel Service Hungary Kft., an affiliate of the Russian mining and metals company Mechel, has decided to limit its local engagement to selling Mechel's steel products

<sup>54</sup> According to an ISD statement, one of its new owners is Swiss-based steel trader Carbofer, which is itself co-owned by Russian businessman Alexander Katunin (Olearchyk, 2010).

<sup>55</sup> Another Hungarian source mentions VEB as a company that comprises the Russian owners of ISD Dunafer (Hvg.hu, 2014).

<sup>56</sup> Interviews with András Deák and Zoltán Borbély by Vs.hu (Lebhardt, 2014).

to Hungarian customers. Mechel Service Hungary was registered in 2010 with headquarters in Budapest and a share capital of only HUF 500,000. Mechel is controlled by its chairman of the board of directors, Igor Zyuzin. Mechel Service Hungary is owned by Mechel through the Dutch-based Mechel Service Global B.V, a subsidiary founded in 2009 which specialises in selling Mechel's rolled products.

### 3.7. Machinery

There have been a few Russian capital-related projects in Hungary's machinery worth mentioning.

1. In 2008, Ganz Machinery Works Holding Zrt. started a joint venture with its Russian state-owned partner Transportno-Tekhnologicheskoye Mashinostroyeniye (TTM), which is owned by Atomenergomash. The company created by the two partners is called Ganz Engineering and Energetics Machinery Kft. In 2010, TTM was replaced by Tsentralnoye Konstruktorskoye Byuro Mashinostroyeniya (TsKBM). TsKBM is also owned by Atomenergomash, which is owned by Atomenergoprom, an affiliate of Rosatom. TsKBM is a 51 percent owner of the joint venture. Ganz Engineering and Energetics Machinery is involved, among other things, in the manufacture and installation of hydromachines, nuclear power station machinery and oil drilling equipment. The company has unique knowledge and experience in Central Europe in planning and manufacturing small-series products. Its high-capacity power plant pumps are also in demand in the Russian and Ukrainian nuclear industry (Ganz, n.a.).
2. A Russian group (Concern Tractor Plants/Agromash Holding B.V.<sup>57</sup>) took over Austria's Vogel & Noot in 2009, including its two Hungarian agricultural machinery factories. One of them (Vogel & Noot Mezőgépgyár Kft.) produces ploughs in the city of Mosonmagyaróvár, close to Austria and Slovakia; the other one (Vogel & Noot Talajtechnika Kft.), located in the city of Törökszentmiklós in Central Hungary, produces cultivators, compact disc harrows, subsoilers, packer and rollers. Production in Mosonmagyaróvár began in 1993, while in Törökszentmiklós it started in 2008.
3. Established in 1990, Uraltrak Kft. (formerly called Mátracselex Kft.) is the only official Hungarian dealer of Russia's Chelyabinsk Tractor Plant–Uraltrak; its site is located in a village northeast of Budapest.<sup>58</sup> Chelyabinsk Tractor Plant is involved in the engineering and production of industrial tractors and engines (Uraltrak, n.a.). Chelyabinsk Tractor Plant is owned by the Russian state-owned tank and railway car manufacturer Uralvagonzavod.

<sup>57</sup> Concern Tractor Plants (CTP), the previous parent company, is now part of Machinery & Industrial Group N.V. (M&IG; initially it was operating under the name of Concern Tractor Plants N.V.), which is registered in the Netherlands and has become the holding company for the former. However, the group is managed by CTP, which has its headquarters in Russia. The Dutch-registered Agromash Holding B.V. also belongs to M&IG. M&IG is a leading manufacturer of earthmoving machinery. In 2010, through a debt restructuring, Vneshekonombank acquired 100 percent of M&IG shares but did not obtain control over the company. Most of the shares had been held by Mikhail Bolotin.

<sup>58</sup> Gábor Reppa drew our attention to this company.



4. After its privatisation in 1993, for a long time the Russians continuously held shares in DKG-East Oil and Gas Equipment Manufacturing Zrt. (and its predecessors), a manufacturer of equipment for the oil, gas and petrochemical industries. It was only a long time after 1993 that Russian ownership interest in the company, which is now called OT Industries–DKG Machine Manufacturing Zrt., ceased. Meanwhile, not only have the owners of the company changed but so have the target markets of its products. Various companies with Russian interests, including Gazprom and Interprokom, ÁÉB, Firthlion, Saturley Holdings Ltd. and Invest-Bond, were also among its owners (Csabai, 2007). As far as individual owners are concerned, Megdet Rakhimkulov is also among the previous owners (HVG, 2006).

### 3.8. *Logistics and transportation*

Hungary's non-energy/utility and non-telecom infrastructure-related industries have also been at the forefront of Russian investors' interest, though on the whole their investment efforts have not been successful thus far.

- Magnit, Russia's largest grocery retailer by revenue and number of stores, announced its plans for Eastern Hungary in December 2013.<sup>59</sup> Finally, despite the crisis in Ukraine, it seemed in May 2014 that the project to build a logistics centre and a transport department with a fleet of 1,000 trucks in Eastern Hungary was greenlighted; it would have created over 2,000 jobs.<sup>60</sup> But in August 2014 the project was put on hold, probably due to the war situation in Ukraine and the Russian embargo. Investment plans had raised serious concerns among Hungarian carriers who had predicted the losses of thousands of jobs in Hungary. The company would employ Hungarian drivers who would drive vehicles with Hungarian license plates. Hungary's geographic location and the agricultural base might have played a role in the investment decision. A great advantage of the Záhony area in Northeastern Hungary at the Hungarian–Ukrainian border is that it has broad-gauge lines. Poland was also in competition for the logistics centre. Trucks carrying products to Magnit from Western Europe are currently going to Russia via Belarus. Part of the food supplies would come from Hungary, which is not a novelty, since in 2012 and 2013 Magnit had bought food products from Hungary in the value of EUR 12 million (HUF 3.6 billion) (Origó, 2014; Szakonyi, 2014). Some of the Magnit owners and managers were already present in the Hungarian market, through their involvement in two vineyard and winery companies (Monte Tokaj Kft. and Winexport Kft.) (Batka, 2014; Hvg.hu, 2015c).
- The issue of Záhony has always been at the forefront of Russo–Hungarian relations, but thus far it has proved a failure. Záhony is in competition with Slovakia and Poland. Registered in 2003, Transzkontinentális Logisztika Hungary Rt. aimed at setting up and operating an international warehouse and logistics centre in Záhony (Menedzsment Fórum, 2004). But after its liquidation (which began in 2006), the company was struck from the register in 2008.

<sup>59</sup> Sergei Galitsky is the founder and largest shareholder of Magnit.

<sup>60</sup> In December 2013, 1,500 new jobs were mentioned as a possibility (Hvg.hu, 2013).

- On top of these initiatives, both Slovakia and Hungary raised the idea of building a broad-gauge railway through their countries, but no progress has been made.
- The history of Malév Hungarian Airlines Zrt. is another story of failure. Malév was under Russian control for three years.<sup>61</sup> Owned by Boris Abramovich, Magdolna Költő and Kálmán Kiss, AirBridge Zrt. became the 99.95 percent owner of Malév in April 2007. The Russian partner had promised funding and passengers. The basic concept was to bring passengers headed from Asia to Europe to Budapest, and transferring them to flights operated by Malév which would bring them to their European destinations. But at the end of the day, the privatization commitment was not met, and the restructuring of Malév failed to even commence (Gépnarancs, 2012). After the bankruptcy of companies belonging to the Russian airline alliance AiRUnion, controlled by the Abramovich brothers, Boris Abramovich's 49.5 percent stake was taken over by Vneshekonombank in 2009 (while as a result of taking over Kálmán Kiss's stake, Magdolna Költő's stake in AirBridge increased to 50.5 percent, i.e. Malév always remained "Hungarian airlines"). Malév was renationalised in 2010 and finally went bankrupt in 2012. However, VEB still holds a claim to roughly EUR 110 million, and Russia continues to insist on the repayment of this debt (Hvg.hu, 2015a; Fóti, 2015).

### *3.9. Real estate and Russians living in Hungary*

The presence of Russian players in Hungary's real estate market is a visible phenomenon, though according to the Moscow-based real estate agency Gordon Rock, Hungary is not among the top 15 destinations for residential real estate purchases by Russians. Rankings for 2008, 2009 and 2010 show that the main target market was Bulgaria. Three other countries in Central and Eastern Europe, Montenegro (No. 3), the Czech Republic (No. 5) and Latvia (No. 7), were on the 2010 list. In 2009, Latvia was not yet among the top 15 destinations (Gordon Rock, 2010; Metrosfera, n.a.).

In 2013, Russian citizens claimed first place among non-EU foreigners buying residential real estate in Hungary. EU citizens, by contrast, are no longer obligated to obtain permits. The five-year period of derogation, which had allowed Hungary to impose such a requirement on EU citizens, ended on 1 May 2009. In 2013, 1,365 foreigners, including 510 Russians, 165 Chinese and 109 Ukrainians, were granted permits to acquire a total of 1,267 real estates. Among permits issued to Russians in 2013, Zala County in the country westernmost region was the most attractive destination (with 283 permits), followed by Budapest (132). Data for the period between 2007 and 2013 show the growing number of Russian residential real estate owners in Zala County, with special attention to the spa city of Hévíz (Ingatlanmenedzser.hu, 2009; Világgazdaság, 2009; Pénzcentrum, 2011; Napi.hu, 2014).

In early May 2015, it was announced that the only five-star hotel in Hévíz, the 232-room Lotus Terme Hotel & Spa, had passed into Russian ownership. The operator of

<sup>61</sup> However, Malév's predecessor was the Hungarian–Soviet Maszovlet Rt., which was set up in 1946.

the hotel remained the same, however. Incorporated in April 2015 and headquartered in Budapest, the new owner is AEG Ingatlanhasznosító Zrt., which is represented by three Russian individuals but is owned by the Cottian Property Ltd. registered in Cyprus. One of the persons authorised to represent AEG Ingatlanhasznosító is Alexandr Baranov, a co-owner of 1000 Út Kft., a leading inbound travel agency, which was registered in Hungary in 2001 (Szalma Baksi, 2015).

An example for the presence of Russians in Hungarian spa areas is a thermal bath in the city of Nagybajom in Somogy County, which was acquired by Timax Kft. in 2008. The latter was founded in 1997 and is owned by two individuals. It is also a story of failure. News reports in January 2012 said that the planned investment would not materialise (F Szarka, 2008, 2012; Körtési, 2012). The thermal bath and the land plot went up for sale.

Hungary is interesting for Russian tourists primarily because of medical tourism. Reportedly, some 70 percent of Russian tourists participate in organized trips. However, the number of Russian tourists arriving in Hungary may fall in 2015 due to the Russian–Ukrainian conflict and the Russian ruble crisis (Napi Gazdaság Online, 2015). Central Statistical Office (KSH), the number of Russian citizens residing in Hungary at the beginning of 2014 was only 3,657 (Table 14; KSH, 2014). The editor-in-chief of Hungary’s Russian-language newspaper *Rossiyskiy Kurier* claims that the real number is well above 20,000, while the number of Russian-speaking people living in Hungary is between 50,000 and 100,000 (Bendarzsevszkij, 2011). According to the Hungarian census of 2011, 13,337 persons had indicated that they are Russian, which marked an increase over the figure of 5,512 in 2001 (KSH, n.a.). Recently, many Russians became Hungarian citizens by abusing the system for obtaining Hungarian citizenship through the simplified naturalisation process (Szalai, 2015). Regarding the Hungarian residence permit bonds, media sources in Hungary argue that Chinese are by far the greatest buyers (Bors, 2015).

Gábor Reppa, a Hungarian expert, told the author that in his experience, the creation of a large number of small and medium-sized companies with Russian capital was, in large part, a result of the fact that it was much simpler for an executive officer/owner of an operating company to obtain a visa for an extended state (type “D”). Moreover, if the company did actual business, then they could request a residence permit. This aspect has been more prevalent since the introduction of the Schengen visa.<sup>62</sup> Before entering the EU in 2004, Hungary imposed visa requirements on Russian citizens in June 2001, while Poland, by contrast, waited until the last minute to introduce a visa regime (it was done with effect from October 2003).

<sup>62</sup> Personal communication, 5 June 2013. However, he now believes that the process described above is not that active, though it does exist (personal communication, 11 May 2015).

### 3.10. *Other industries and companies*

In addition to the industries analysed here, Russian companies operate in a wide variety of industries in Hungary. Two examples are as follows:

- The result of Russo–Hungarian cooperation in nanotechnology is the establishment of the company Nanovo Kft. The joint venture was created by two Russian private companies and Hungary’s Miskolc Holding Municipality Asset Management Corporation Zrt. in Miskolc in 2007. In 2009, the latter sold its 50 percent stake to a private company, Lenbiz Kft., based in the Hungarian city of Szeged in Southern Hungary.<sup>63</sup> The headquarters of Nanovo also moved from Miskolc to Szeged. The company’s share capital was reduced to only HUF 500,000, down from HUF 50 million previously. The successful and well-known project of Nanovo is linked to Eurotex Kft., a textile company with a site in the city of Hódmezővásárhely in South-East Hungary, whose products are treated with colloidal silver.
- Another relatively widely known Russian-owned company is LIT Budapest Kft. Incorporated in 2006, LIT Budapest deals with disinfection technologies, including the use of UV in the treatment of drinking water, wastewater, technological water and water for swimming pools and spas. The company’s main activities include the sale and installation of equipment, maintenance and servicing (LIT Budapest, n.a.). Founded in 1991, LIT is among the world’s top three developers and manufacturers of UV systems for water, air and surface disinfection (LIT, n.a.).

## 4. Summary and conclusions

Russian FDI in Hungary attracted most attention at the turn of the century (due to the acquisitions of shares in BorsodChem and TVK by Gazprom) and at the beginning of the 2010s (due to the acquisition of shares in Mol by Surgutneftegaz). In both cases, Russian attempts ultimately proved to be unsuccessful, and thus became examples of legitimate fears of Russian capital.

As it was limited to the end of both 2009 and 2010, Hungary’s leading position – in statistical terms – in Central and Eastern Europe in terms of attracting Russian FDI proved to be temporary, and was only due to the Surgutneftegaz deal. Statistics offer limited help in getting a real picture of Russian FDI in Hungary. In many cases, indirect FDI was observed. Consequently, the size and variety of Russian presence can only be estimated by analysing company and media sources in meticulous detail. But although the presence of Russian investors in Hungary is more significant than official statistics indicate, the overall picture does not change much. Not only do the official statistics say that Russian FDI plays a limited role in Hungary, but company data also suggest this. Our research shows that among the top 20 non-financial Russian MNEs, only a

<sup>63</sup> Currently based in Békéscsaba, a city in Southeast Hungary, Lenbiz Kft. is under liquidation.

few companies are active investors in Hungary. Several large Russian companies are being targeted by the EU and US sanctions.

We have found that the motivations behind Russian FDI in Hungary are complex. Among other things, natural-resource-seeking FDI also appeared, such as in the case of Serbia's Russian-controlled NIS, which is performing hydrocarbon exploration. Russian oil and gas companies aim at controlling the entire value chain from production to the end user (i.e. to vertically integrate their businesses), but the EU's Third Energy Package works in ways that runs counter to such expectations.

Company data and our case studies demonstrate that the activities of Russian investors in Hungary analysed here were paved with failures. These have been evident in both divestments and unrealised plans. Kalotay et al. (2014) suggest that a low share of Russian investment in the Visegrád countries may be referred to as business opportunities that the Russian parties failed to exploit. Our case studies confirm this assumption in the case of Hungary.

In recent years, the investment climate in Hungary has been unfavourable. It is clear that the controversial "crisis tax" has negatively affected Russian players. However, the so-called "Robin Hood" tax is still a (now larger) burden on energy firms. And a new tax on public utility pipelines and cables was also introduced.

When the issue of the Surgutneftegaz deal was finally concluded, this meant that Russo-Hungarian relations were relieved of a serious burden. In fact, ultimately the deal did not turn out to be disadvantageous for Surgutneftegaz: they bought the stake for EUR 1.4 billion and sold it for EUR 1.88 billion. Nonetheless, the case left its mark on Russian high politics (at least for a while). Not only did Vladimir Putin publicly discuss the transaction in November 2010 (Origo, 2010), but he also wrote about it in one of his articles published before the presidential election of February 2012. However, at that time, he only referred to the case without mentioning names (i.e. he wrote about Russians being deprived of their ownership rights), concluding that it was necessary to strengthen the economic and political support of Russian companies in foreign markets (Putin, 2012<sup>64</sup>). The latter is not a new idea. Nor is it a novel idea, however, that improving transparency would certainly reduce fears of Russian investment; and, incidentally, such apprehensions are not limited to Central and Eastern Europe.

As for future Russian investments, FDI projects that are similar in scope to the Surgutneftegaz deal are not likely in Hungary in the near future. However, some investments are still on the horizon, though they are accompanied by uncertainty. The largest project involving OFDI, but also other types of transactions, could have been the construction of the Hungarian section of South Stream. Another significant FDI project

<sup>64</sup> Nyilas (2012) drew our attention to this article.

whose future is unclear is that of Magnit. Finally, the extension of the nuclear power plant near Paks is not an FDI project, but it is economically very significant.

Efforts to monitor and track Russian FDI remain an important task, particularly because of the sensitivity of the issue under the current geopolitical circumstances.

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## Tables

**Table 1. The top 20 Russian non-financial multinational enterprises, by foreign assets, end of year, 2011 (Millions of dollars)**

Rank	Name	One or two main industries (% of state ownership)	Status	Foreign assets
1	Lukoil	Oil & gas extraction / refineries	Listed	29,159
2	Gazprom	Oil & gas extraction / gas distribution	Listed (State – 50.002%)	21,767
3	Evraz	Iron & steel / mining of metal ores and coals	Listed (only abroad)	8,210
4	Mechel	Iron & steel / mining of metal ores and coals	Listed	6,365
5	Sovcomflot	Sea transport	Unlisted (State – 100%)	5,838
6	Sistema	Conglomerate	Listed	5,207
7	Severstal	Iron & steel / mining of metal ores and coals	Listed	5,194
8	UC RUSAL	Non-ferrous metals / mining of metal ores	Listed	4,611
9	NLMK	Iron & steel / mining of metal ores	Listed	4,226
10	Atomredmetzoloto	Mining of uranium ores	Unlisted (State – 100%)	3,731
11	TNK-BP	Oil & gas extraction / refineries	Listed	2,940
12	TMK	Metal tubes	Listed	2,394
13	MMK	Iron & steel / mining of metal ores and coals	Listed	2,101
14	Norilsk Nickel	Non-ferrous metals / mining of metal ores	Listed	1,968
15	Zarubezhneft	Oil extraction / refineries	Unlisted (State – 100%)	1,834
16	NordGold	Mining of gold ores	Listed (only abroad)	1,695
17	Inter RAO UES	Electricity production and supply	Listed (State – 60.2%)	1,433
18	Rosneft	Oil & gas extraction / refineries	Listed (State – 75.2%)	1,045
19	FESCO	Sea and railway transportation	Listed	747
20	Acron	Agrochemicals	Listed	721
			<b>Total</b>	<b>111,186</b>

Source: Kuznetsov (2013).

**Table 2. Russian FDI stock in the CEE countries,<sup>a</sup> according to data provided by the Central Bank of Russia, end of year, 2009–2013 (Millions of dollars)**

Rank <sup>b</sup>	2009		2010		2011		2012		2013	
	Country	Value	Country	Value	Country	Value	Country	Value	Country	Value
1	Hungary	2,266	Hungary	2,230	Bulgaria	2,439	Bulgaria	2,854	Latvia	3,062
2	Bulgaria	1,586	Bulgaria	1,884	Serbia	1,488	Serbia	1,784	Bulgaria	2,870
3	Lithuania	1,380	Lithuania	1,420	Lithuania	1,444	Czech Rep.	1,598	Czech Rep.	1,842
4	Montenegro	1,339	Czech Rep.	1,192	Czech Rep.	1,309	Lithuania	1,335	Serbia	1,788
5	Czech Rep.	1,336	Montenegro	896	Montenegro	935	Montenegro	1,109	Lithuania	1,411
6	Poland	596	Bosnia & H.	678	Latvia	704	Latvia	941	Montenegro	1,232
7	Estonia	589	Serbia	623	Bosnia & H.	561	Bosnia & H.	725	Bosnia & H.	877
8	Bosnia & H.	541	Poland	581	Poland	545	Poland	589	Poland	618
9	Latvia	535	Latvia	473	Croatia	250	Croatia	355	Estonia	412
10	Serbia	394	Romania	258	Hungary	228	Estonia	276	Croatia	399
11	Croatia	206	Croatia	226	Estonia	220	Romania	138	Hungary	316
12	Romania	63	Estonia	149	Romania	147	Hungary	107	Slovakia	117
13	Slovakia	48	Slovenia	59	Slovenia	64	Slovakia	78	Slovenia	72
14	Slovenia	14	Slovakia	52	Slovakia	59	Slovenia	45	Romania	36
15	Albania	–	Albania	–	Albania	–	Macedonia	1	Albania	2
16	Macedonia	–	Macedonia	–	Macedonia	–	Albania	1	Macedonia	1

<sup>a</sup> Excluding the CIS and Georgia.

<sup>b</sup> In descending order.

Source: Own compilation based on CBR (2014).

**Table 3. Russian FDI flows to the CEE countries,<sup>a</sup> according to data provided by the Central Bank of Hungary, net, 2007 – Q3 2014 (Millions of dollars)**

	2007	2008	2009	2010	2011	2012	2013	Q1–Q3 2014
Albania	0	0	0	0	0	0	1	3
Bosnia and Herzegovina	1	55	287	94	104	149	78	121
Bulgaria	125	441	261	319	522	716	554	244
Croatia	95	75	13	23	103	31	71	65
Czech Republic	248	319	142	360	337	265	340	303
Estonia	13	29	11	21	30	85	130	100
Hungary	51	542	1,789	48	-2,724	67	155	43
Latvia	79	166	78	147	328	348	568	402
Lithuania	57	57	64	49	66	28	46	-95
Macedonia	0	0	0	0	1	3	1	3
Montenegro	188	173	85	117	160	185	173	141
Poland	28	-50	13	-2	30	-2	73	17
Romania	1	25	39	196	-96	-1	-101	1
Serbia	44	11	609	208	372	63	-39	-32
Slovakia	13	29	7	11	19	49	32	18
Slovenia	49	9	2	3	10	18	29	59

<sup>a</sup> Excluding the CIS and Georgia.

Source: Own compilation based on CBR (2015b).

**Table 4. Russian FDI stock in Hungary, according to data provided by the Central Bank of Hungary, BPM5 methodology,<sup>a</sup> end of year, 2001–2012 (Millions of euros)**

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
<i>Excluding SPEs</i>												
Total	NA	NA	NA	NA	NA	NA	NA	-210.3	1,128.5	1,516.9	-70.2	-96.4
Equity capital and reinvested earnings	64.1	67.7	74.1	94.7	-5.2	17.1	697.3	24.7	1,396.8	1,660.4	19.9	26.7
Other capital	NA	NA	NA	NA	NA	NA	NA	-235.0	-268.3	-143.5	-90.1	-123.0
<i>Including SPEs</i>												
Total	NA	NA	NA	NA	NA	19.4	699.8	-447.8	1,130.0	1,514.4	-74.7	-102.1
Equity capital and reinvested earnings	NA	NA	NA	NA	NA	19.4	699.8	26.3	1,398.3	1,662.0	19.6	28.6
Other capital	NA	NA	NA	NA	NA	NA	NA	-474.1	-268.3	-147.6	-94.2	-130.7

NA – Not available.

<sup>a</sup> See MNB (2014g).

Source: Own compilation based on MNB (2014a, 2014b).

**Table 5. Russian FDI stock in Hungary, according to data provided by the Central Bank of Hungary, BPM6 methodology,<sup>a</sup> end of year, 2001–2013 (Millions of euros)**

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
<i>Excluding SPEs</i>													
Total	NA	NA	NA	NA	NA	NA	NA	-210.3	1,128.5	1,516.9	-70.2	-95.9	-57.4
Equity	64.1	67.7	74.1	94.7	-5.2	17.1	697.3	24.7	1,396.8	1,660.4	19.9	26.7	35.6
Debt instruments	NA	NA	NA	NA	NA	NA	NA	-235.0	-268.3	-143.5	-90.1	-122.5	-92.9
<i>Including SPEs</i>													
Total	NA	NA	NA	NA	NA	NA	NA	-447.8	1,130.0	1,514.4	-74.7	-101.7	-71.3
Equity	NA	NA	NA	NA	NA	19.4	699.8	26.3	1,398.3	1,662.0	19.6	28.6	37.5
Debt instruments	NA	NA	NA	NA	NA	NA	NA	-474.1	-268.3	-147.6	-94.2	-130.2	-108.8

NA – Not available.<sup>a</sup> See MNB (2014h).

Source: Own compilation based on MNB (2015d,

2015e).

**Table 6. Russian FDI stock in Hungary, according to data provided by the Central Bank of Hungary, BPM6 methodology,<sup>a</sup> detailed breakdown, end of year, 2008–2013 (Millions of euros)**

Year	Equity			Debt instruments					
	Total	Excluding fellows	Between fellow <sup>b</sup>	Assets		Liabilities		Total	Between fellows <sup>b</sup>
				Excluding fellows	Between fellows <sup>b</sup>	Excluding fellows	Between fellows <sup>b</sup>		
<i>Excluding SPEs</i>									
2008	-210.3	24.7	0.0	-235.0	0.0	241.2	0.0	6.3	
2009	1,128.5	1,396.8	0.0	-268.3	0.0	274.1	0.0	5.9	
2010	1,516.9	1,660.4	0.0	-143.5	0.0	155.4	1.5	10.5	
2011	-70.2	19.9	0.0	-90.1	0.0	108.0	5.0	12.9	
2012	-95.9	26.7	0.0	-122.5	8.0	131.7	0.0	17.1	
2013	-57.4	35.6	-1.7	-92.9	0.0	101.7	5.6	3.1	
<i>Including SPEs</i>									
2008	-447.8	26.3	0.0	-474.1	0.0	480.3	0.0	6.3	
2009	1,130.0	1,398.3	0.0	-268.3	0.0	274.1	0.0	5.9	
2010	1,514.4	1,662.0	0.0	-147.6	0.0	160.1	1.5	11.1	
2011	-74.7	19.6	0.0	-94.2	0.0	112.7	5.0	13.5	
2012	-101.7	28.6	0.0	-130.2	8.0	140.0	0.0	17.7	
2013	-71.3	37.5	-1.7	-108.8	0.0	118.1	5.6	3.7	

<sup>a</sup> See MNB (2014h).

<sup>b</sup> Ultimate controlling parent is non-resident.

Source: Own compilation based on MNB (2015d, 2015e).

**Table 7. Russian FDI stock in Hungary, according to the Central Bank of Russia, end of year, 2009–2013 (Millions of dollars)**

2009	2010			2011			2012			2013		
	Total	Equity	Debt instruments	Total	Equity	Debt instruments	Total	Equity	Debt Instruments	Total	Debt instruments	
2,266	2,266	2,192	39	228	228	–	106	65	41	316	253	63

Source: CBR (2014).

Table 8. Russian FDI flows into Hungary, according to the Central Bank of Hungary, BPM5 methodology,<sup>a</sup> quarterly data, 2007–2012 (Millions of euros)

	2007				2008				2009				2010			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<i>Excluding SPEs</i>																
Total, net	-5.5	-7.7	-53.9	-7.8	-47.3	-664.3	-69.8	34.0	24.0	778.9	0.3	98.1	74.0	140.5	-55.3	110.7
Credit	-4.0	-5.6	-8.2	-7.7	34.0	74.2	46.0	54.4	86.1	879.5	66.5	127.6	116.2	183.5	72.2	137.6
Debit	1.5	2.1	45.8	0.1	81.2	738.6	115.8	20.4	62.1	100.6	66.3	29.5	42.2	43.0	127.5	26.9
Equity, net	0.2	0.5	-0.2	0.7	0.00	-677.4	0.00	5.8	-4.3	789.7	-0.1	-0.1	0.3	0.3	0.3	0.3
Credit	0.3	0.6	0.1	0.7	0.00	0.00	0.00	5.8	0.00	789.8	0.00	0.00	0.3	0.3	5.8	0.3
Debit	0.1	0.1	0.2	0.00	0.00	677.4	0.00	0.00	4.3	0.1	0.1	0.1	0.00	0.00	5.5	0.00
Other capital, net	2.1	2.1	-45.4	0.1	-48.9	12.5	-71.7	26.5	29.4	-45.4	-40.4	57.5	45.1	112.2	-84.1	80.2
Credit	3.0	2.1	0.1	0.2	32.4	72.5	44.1	46.8	87.2	51.0	25.8	86.9	87.3	153.5	37.9	107.1
Debit	0.9	0.1	45.5	0.1	81.2	60.0	115.8	20.4	57.8	96.4	66.1	29.4	42.2	41.3	122.0	26.9
<i>Including SPEs</i>																
Total, net	-16.1	7.8	-77.4	-19.0	-66.9	-681.8	-96.8	17.6	287.6	778.9	0.3	98.1	76.9	138.8	-55.6	111.0
Credit	-4.0	22.2	-8.2	-7.7	34.0	74.3	46.0	56.4	361.1	879.5	66.5	127.6	119.1	183.5	72.2	138.0
Debit	12.1	14.3	69.2	11.3	100.9	756.1	142.8	38.8	73.5	100.6	66.3	29.5	42.2	44.8	127.8	27.0
Equity, net	0.2	27.7	-0.2	0.5	0.00	-677.4	0.00	5.8	-4.3	789.7	-0.1	-0.1	0.3	0.3	0.3	0.3
Credit	0.3	27.8	0.1	0.7	0.00	0.00	0.00	5.8	0.0	789.8	0.0	0.0	0.3	0.3	5.8	0.3
Debit	0.1	0.1	0.2	0.2	0.00	677.4	0.00	0.00	4.3	0.1	0.1	0.1	0.00	0.00	5.5	0.00
Other capital, net	-8.6	-9.6	-68.9	-10.9	-68.6	-5.0	-98.7	10.0	292.9	-45.4	-40.4	57.5	48.0	110.5	-84.4	80.5
Credit	3.0	2.7	0.1	0.2	32.4	72.5	44.1	48.8	362.1	51.0	25.8	86.9	90.2	153.5	37.9	107.5
Debit	11.6	12.3	69.0	11.1	100.9	77.5	142.8	38.8	69.2	96.4	66.1	29.4	42.2	43.0	122.3	27.0

(Table continued)

**Table 8 (continued). Russian FDI flows into Hungary, according to data provided by the Central Bank of Hungary, BPM5 methodology,<sup>a</sup> quarterly data, 2007–2012 (Millions of euros)**

	2011				2012				2013s			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<i>Excluding SPEs</i>												
Total, net	-10.1	61.1	-1,848.6	-3.9	4.8	-4.7	-35.1	11.1	NA	NA	NA	NA
Credit	50.2	119.6	41.3	32.3	39.7	34.8	26.2	41.5	NA	NA	NA	NA
Debit	60.3	58.6	1,890.0	36.3	34.8	39.5	61.3	30.4	48.1	41.7	57.4	51.6
Equity, net	1.3	1.2	-1,860.8	1.3	0.00	0.00	0.00	0.00	0.00	6.4	0.00	6.3
Credit	1.3	1.2	1.2	1.3	0.00	0.00	0.00	0.00	0.00	6.4	0.00	6.3
Debit	0.00	0.00	1,862.0	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Other capital, net	-13.7	57.2	9.6	-7.7	3.5	-6.1	-36.6	9.5	-19.3	21.0	-24.9	28.4
Credit	46.6	115.8	37.5	28.6	38.4	33.4	24.7	39.9	28.8	55.4	32.5	80.0
Debit	60.3	58.6	27.9	36.3	34.8	39.5	61.3	30.4	48.1	34.4	57.4	51.6
<i>Including SPEs</i>												
Total, net	-10.1	61.0	-1,848.6	-3.9	4.9	-4.7	-37.6	10.2	NA	NA	NA	NA
Credit	50.3	119.6	41.3	32.7	39.7	34.8	26.2	41.6	NA	NA	NA	NA
Debit	60.4	58.6	1,890.0	36.6	34.8	39.5	63.8	31.4	NA	NA	NA	NA
Equity, net	1.3	1.2	-1,860.8	1.3	0.00	0.00	0.00	0.00	0.00	6.4	0.00	6.3
Credit	1.3	1.2	1.2	1.3	0.00	0.00	0.00	0.00	0.00	6.4	0.00	6.3
Debit	0.00	0.00	1,862.0	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Other capital, net	-13.8	57.2	9.6	-7.7	3.5	-6.1	-39.1	8.5	-20.6	20.2	-26.3	23.5
Credit	46.6	115.8	37.5	28.9	38.4	33.4	24.7	39.9	31.6	55.4	32.5	80.0
Debit	60.4	58.6	27.9	36.6	34.8	39.5	63.8	31.4	52.2	35.2	58.8	56.5

NA – Not available.<sup>a</sup> See MNB (2014g).

Source: Own compilation based on MNB (2014e, 2014f).



**Table 9. Russian FDI flows into Hungary, according to data provided by the Central Bank of Hungary, BPM6 methodology,<sup>a</sup> quarterly data, 2014 (Millions of euros)**

	Q1 2014	Q2 2014	Q3 2014	Q4 2014
<i>Excluding SPEs</i>	18.9	0.8	16.2	408.0
<i>Excluding SPEs as well as capital in transit and restructuring of asset portfolios</i>	18.9	0.8	16.2	57.3

<sup>a</sup> See MNB (2014b).

Source: Own compilation based on MNB (2015f, 2015g).

**Table 10. Russian FDI flows into Hungary, according to data provided by the Central Bank of Russia, quarterly data, net, 2007 – Q3 2014 (Millions of dollars)<sup>a</sup>**

	2007				2008				2009				2010				2011				2012				2013				2014							
	Σ	1	2	3	Σ	1	2	3	Σ	1	2	3	Σ	1	2	3	Σ	1	2	3	Σ	1	2	3	Σ	1	2	3	Σ							
Total	51	473	22	25	21	542	2	1,781	4	2	1,789	2	3	4	39	48	-23	2	-2,713	10	-2,724	8	20	30	9	67	32	48	57	18	155	18	9	16	43	
Equity	51	447	3	7	5	462	2	1,781	4	2	1,789	2	3	4	-1	8	15	7	-2,713	10	-2,681	8	20	30	31	89	32	32	32	16	112	17	9	16	42	
Reinvested earnings	0	27	19	18	16	80	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	-4	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Debt instruments	0	0	0	0	0	0	0	0	0	0	0	0	0	0	40	40	-38	0	0	0	-38	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0

<sup>a</sup> Balance of payments data, outflows minus inflows.

Source: CBR (2015b).

**Table 11. Russian FDI flows into Hungary, according to data provided by the Central Bank of Hungary, BPM5 methodology,<sup>a</sup> detailed breakdown, yearly data, 2001–2012 (Millions of euros)**

Year	Equity capital			Reinvested earnings	Equity capital and reinvested earnings	Other capital			Total
	Increase	Decrease	Net			Liabilities, net	Assets, net	Net liabilities	
	(1)	(2)	(3) = (1) – (2)			(4)	(5) = (3) + (4)	(6)	
<i>Excluding SPEs</i>									
2001	6.7	0.1	6.6	16.5	23.1	-1.4	0.7	-2.1	21.0
2002	0.3	7.2	-7.0	11.2	4.2	-8.5	0.5	-9.0	-4.8
2003	0.5	0.6	-0.1	12.8	12.7	0.9	0.2	0.7	13.4
2004	1.3	0.3	1.0	14.9	15.9	-2.2	-0.2	-2.0	13.9
2005	1.6	1.1	0.4	-7.3	-6.8	-0.6	0.0	-0.6	-7.4
2006	5.0	0.6	4.4	-1.0	3.4	-0.4	2.6	-3.0	0.3
2007	1.7	0.4	1.3	-35.1	-33.8	-43.0	-1.8	-41.1	-74.9
2008	5.8	677.4	-671.5	5.8	-665.7	-25.4	56.2	-81.6	-747.3
2009	789.8	4.6	785.2	115.0	900.2	0.1	-1.0	1.1	901.3
2010	6.7	5.5	1.2	115.2	116.4	1.1	-152.3	153.4	269.9
2011	5.0	1,862.0	-1,857.0	10.0	-1,846.9	3.4	-41.9	45.3	-1,801.6
2012	0.00	0.00	0.00	6.0	6.0	-0.7	29.0	-29.7	-23.8
<i>Including SPEs</i>									
2006	5.0	0.6	4.4	-0.9	3.5	-2.4	28.4	-30.8	-27.4
2007	28.9	0.6	28.3	-35.0	-6.7	-50.8	47.1	-97.9	-104.6
2008	5.8	677.4	-671.5	5.8	-665.7	-25.4	136.8	-162.2	-827.9
2009	789.8	4.6	785.2	115.1	900.3	0.1	-264.5	264.6	1,164.9
2010	6.7	5.5	1.2	115.2	116.5	1.1	-153.4	154.5	271.0
2011	5.0	1,862.0	-1,857.0	10.1	-1,846.9	3.4	-41.9	45.3	-1,801.6
2012	0.00	0.00	0.00	6.0	6.0	-0.7	32.5	-33.2	-27.2

<sup>a</sup> See MNB (2014g).

Source: Own compilation based on MNB (2014c, 2014d).

**Table 12. Russian FDI flows into Hungary, according to data provided by the Central Bank of Hungary, BPM6 methodology,<sup>a</sup> yearly data, net, 2001–2013 (Millions of euros)**

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
<i>Excluding SPEs<sup>b</sup></i>													
Total	21.0	-4.8	13.4	13.9	-7.4	0.3	-74.9	-747.3	901.2	269.9	-1,801.6	-23.4	29.1
Equity	23.1	4.2	12.7	15.9	-6.8	3.4	-33.8	-665.7	900.2	116.4	-1,846.9	6.0	7.4
Debt instruments	-2.1	-9.0	0.7	-2.0	-0.6	-3.0	-41.1	-81.6	0.9	153.4	45.3	-29.3	21.7
<i>Excluding SPEs as well as capital in transit and restructuring of asset portfolios</i>													
Total	21.0	-4.8	13.4	13.9	-7.4	0.3	-74.9	-747.3	901.2	269.9	-1,801.6	-23.4	29.1
Equity	23.1	4.2	12.7	15.9	-6.8	3.4	-33.8	-665.7	900.2	116.4	-1,846.9	6.0	7.4
Debt instruments	-2.1	-9.0	0.7	-2.0	-0.6	-3.0	-41.1	-81.6	0.9	153.4	45.3	-29.3	21.7
<i>Including SPEs</i>													
Total	NA	NA	NA	NA	NA	-27.4	-104.6	-827.9	1,164.7	271.0	-1,801.6	-26.8	20.9
Equity	NA	NA	NA	NA	NA	3.5	-6.7	-665.7	900.3	116.5	-1,846.9	6.0	7.5
Debt instruments	NA	NA	NA	NA	NA	-30.8	-97.9	-162.2	264.5	154.5	45.3	-32.8	13.4

NA – Not available. <sup>a</sup> See MNB (2014h).

<sup>b</sup> As is apparent, the figures remain unchanged when capital in transit and restructuring of asset portfolios are excluded.  
*Source:* Own compilation based on MNB (2015a, 2015b, 2015c).

**Table 13. Russian FDI flows into Hungary, according to data provided by the Central Bank of Hungary, BPM6 methodology,<sup>a</sup> detailed breakdown, yearly data, net, 2001–2013 (Millions of euros)**

Year	Total	Equity				Debt instruments, net		
		Equity other than reinvestment of earnings			Reinvested earnings	Total	Excluding fellows	Between fellows <sup>b</sup>
		Total	Excluding fellows	Between fellows <sup>b</sup>				
<i>Excluding SPEs<sup>c</sup></i>								
2001	21.0	6.6	6.6	0.0	16.5	-2.1	-2.1	0.0
2002	-4.8	-7.0	-7.0	0.0	11.2	-9.0	-9.0	0.0
2003	13.4	-0.1	-0.1	0.0	12.8	0.7	0.7	0.0
2004	13.9	1.0	1.0	0.0	14.9	-2.0	-2.0	0.0
2005	-7.4	0.4	0.4	0.0	-7.3	-0.6	-0.6	0.0
2006	0.3	4.4	4.4	0.0	-1.0	-3.0	-3.0	0.0
2007	-74.9	1.3	1.3	0.0	-35.1	-41.1	-41.1	0.0
2008	-747.3	-671.5	-671.5	0.0	5.8	-81.6	-1.6	-80.0
2009	901.2	785.2	785.2	0.0	115.0	0.9	1.1	-0.2
2010	269.9	1.2	1.2	0.0	115.2	153.4	1.5	152.0
2011	-1,801.6	-1,857.0	-1,857.0	0.0	10.0	45.3	3.3	42.1
2012	-23.4	0.0	0.0	0.0	6.0	-29.3	-13.2	-16.1
2013	29.1	11.9	11.9	0.0	-4.5	21.7	10.5	11.2
<i>Excluding SPEs as well as capital in transit and restructuring of asset portfolios</i>								
2001	21.0	6.6	6.6	0.0	16.5	-2.1	-2.1	0.0
2002	-4.8	-7.0	-7.0	0.0	11.2	-9.0	-9.0	0.0
2003	13.4	-0.1	-0.1	0.0	12.8	0.7	0.7	0.0
2004	13.9	1.0	1.0	0.0	14.9	-2.0	-2.0	0.0
2005	-7.4	0.4	0.4	0.0	-7.3	-0.6	-0.6	0.0
2006	0.3	4.4	4.4	0.0	-1.0	-3.0	-3.0	0.0
2007	-74.9	1.3	1.3	0.0	-35.1	-41.1	-41.1	0.0
2008	-747.3	-671.5	-671.5	0.0	5.8	-81.6	-1.6	-80.0
2009	901.2	785.2	785.2	0.0	115.0	0.9	1.1	-0.2
2010	269.9	1.2	1.2	0.0	115.2	153.4	1.5	152.0
2011	-1,801.6	-1,857.0	-1,857.0	0.0	10.0	45.3	3.3	42.1
2012	-23.4	0.0	0.0	0.0	6.0	-29.3	-13.2	-16.1
2013	29.1	11.9	11.9	0.0	-4.5	21.7	10.5	11.2
<i>Including SPEs</i>								
2006	-27.4	4.4	4.4	0.0	-0.9	-30.8	-30.8	0.0
2007	-104.6	28.3	28.3	0.0	-35.0	-97.9	-97.9	0.0
2008	-827.9	-671.5	-671.5	0.0	5.8	-162.2	-1.6	-160.6

Year	Total	Equity				Debt instruments, net		
		Equity other than reinvestment of earnings			Reinvested earnings	Total	Excluding fellows	Between fellows <sup>b</sup>
		Total	Excluding fellows	Between fellows <sup>b</sup>				
2009	1,164.7	785.2	785.2	0.0	115.1	264.5	1.1	263.4
2010	271.0	1.2	1.2	0.0	115.2	154.5	1.5	153.0
2011	-1,801.6	-1,857.0	-1,857.0	0.0	10.1	45.3	3.3	42.0
2012	-26.8	0.0	0.0	0.0	6.0	-32.8	-13.2	-19.6
2013	20.9	11.9	11.9	0.0	-4.4	13.4	10.5	2.9

<sup>a</sup> See MNB (2014h).

<sup>b</sup> Ultimate controlling parent is non-resident.

<sup>c</sup> As is apparent, the figures remain unchanged when capital in transit and restructuring of asset portfolios are excluded.

Source: Own compilation based on MNB (2015a, 2015b, 2015c).

**Table 14. Russian citizens residing in Hungary at the beginning of the year, 1995–2014**

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Russian	277	1,124	1,708	2,502	2,809	3,002	1,893	2,048	1,794	2,244
Total foreigners	138,101	139,954	142,506	148,263	150,245	153,125	110,028	116,429	115,888	130,109
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Russian	2,642	2,759	2,760	2,787	2,923	3,703	3,483	2,864	3,390	3,657
Total foreigners	142,153	154,430	166,030	174,697	184,358	197,819	206,909	143,361	141,357	140,536

Source: KSH (2014).

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