

## **CONFLICT OF INTEGRATIONS IN THE EAST OF EUROPE: WAYS OF RESOLUTION**

In May 2014 the Institute of Contemporary Development presented the report “Deadlock in the Struggle of Integrations in Europe”<sup>1</sup> to the participants of the Baltic Forum. The choice of Ukraine and (to a lesser extent) of Moldova in favour of the EU integration project and the challenges associated with this choice were described there.

The authors came to the conclusion that the economic and financial burden of solving socio-economic problems in Ukraine and the development of the economy to even minimal growth would be unsustainable separately both for the EU (with other partners) and Russia together with the Eurasian Economic Union (EEU). Therefore, all parties should be interested in joint efforts, including removal of the emerging economic and trade barriers. This is dictated by the economy over which political considerations have been dominating so far.

At present, 15 months later, we consider it relevant to return to the topic of the costs of the choice made by these two countries.

### **“THE EASTERN PARTNERSHIP”**

#### *On the sidelines of Riga Summit*

In May 2015 in Riga Latvia hosted the summit of “the Eastern Partnership” (EaP). The Presidency of Latvia in the EU in general has received positive assessment from a number of authoritative European think tanks. As for the EaP Summit, its perception has been more reserved in comparison to the previous event in Vilnius (November 2013).

After the summit, among the partners of the EU, especially the signatories of the Association Agreements (AA) (Georgia, Moldova and Ukraine), uncertainty remains due to the absence of clear signals from Brussels regarding their three motivations.

Firstly – accession to the European Union at least in the remote perspective. This, however, has never been designated by the European Union as a given.

Since the beginning of the Ukrainian crisis the voices of the politicians and experts considering such a standpoint of the EU to be faulty have become more prominent. In their view, the formal assurance of “the light at the end of the tunnel” will provide an extra (and powerful at that) mobilization resource. It will be easier for

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<sup>1</sup> The final version of the work was published in early 2015 under the title „The Conflict of Two Integrations” in the series “Library of the Institute of Contemporary Development”.

the residents of Georgia, Moldova and Ukraine to survive the current difficulties and future troubles in the course of implementation of transformations agreed upon within the same AAs. In addition, this will strengthen the position of the supporters of the “European choice” in Armenia, then in Belarus and, with greater reservations, in Azerbaijan.

Due to its own problems and the current public attitudes it is extremely difficult for the European Union to decide on taking this kind of move. However, in view of the process of deepening problems for the announced reforms and prolongation of the schedule for their implementation as well as the pressure of large-scale financial injections to overcome these challenges, the scenario of offering membership should not be ruled out.

The second motivation - the elimination of visa regimes. There have been many promises for this prospect from Brussels. They have been fulfilled only for Moldova, but with significant reservations and restrictions and where a large portion of inhabitants have already received Romanian passports. Georgia and Ukraine are still offered to wait, even though these horizons are the sweetest “carrot”, presented by Kiev and Tbilisi to their citizens for passing the difficult period of reforms easier, at least psychologically.

In contrast to the prospects for the EU accession, Brussels encounters more pressure in respect to taking fundamental free travel decisions. They are also quite unpleasant for the EU and the public of the member states, inter alia in the light of the growing migration challenges from the South. In case of internal transformation loses momentum, without noticeable positive impact and growing social unrest in the signatory countries, this challenge will become continuously more tangible for Brussels. However if favourable decision is made, the EU will have to face additional problems, including modernization of the infrastructure to control migration waves.

Thirdly – much needed corrections in the EU priorities and the schedules for the implementation of reform plans stipulated in the AAs due to current and emerging problems in these countries. These plans to a large extent were made in the previous decade, in a significantly different situation and with positive relations with Moscow. However, Brussels has confirmed also during the summit in Riga that it does not intend to lower sights. Moreover, at least on a declarative level, it has put even more emphasis on the previously declared “more-for-more” principle: the scale of economic and financial assistance is directly dependent on the implementation (and adequacy to the schedule) of internal changes already agreed upon by the signatories.

Brussels is further pressed with a choice - whether to firmly adhere to this principle, or turn a blind eye to the inconsistency of schedules to realities and enhance assistance. The second option is already taking a rather noticeable shape, although it will encounter new challenges, especially the burden in dealing with the debt crisis in Greece.

Alongside with that, in assessing the meeting in Riga, the Russian factor should not be discarded. Let's compare the Joint declaration of the summit in Latvia and the final document adopted in Vilnius. With all the attempts to provide it with a more or less optimistic mood in the Riga Declaration a concern regarding further prospects is visible. The main innovation of the summit in Latvia is that for the first time the security and conflict resolution issues have come to the forefront in the list of urgent tasks of the EaP.

These top priorities, besides cooperation in other areas, should logically assign Russia a prominent place in the documents. Nevertheless, both have ignored addressing Russia at all in common - even in the paragraphs devoted to energy or (in Riga) Minsk agreements<sup>2</sup>.

It appears that EU cooperation plans with all six countries along the EaP still do not take Russia into account. This strengthens the confidence of Moscow in the geopolitical motivation of the "Partnership" despite the statements of its authors about their intention to ensure stable and prosperous neighbourhood on the borders of the European Union. Thereby the task of achieving this kind of neighbourhood is being made more complicated, the burden on the EU and its allies is increasing and, accordingly, the question about the relevance of the EaP to the emerging circumstances is valid.

Nick Whitney and Susi Dennison of the European Council on Foreign Relations in their analysis of the European Neighbourhood Policy (ENP) of the EU (which includes also Mediterranean countries) and Riga summit share their opinion. "The bottom line is that the ENP is not so much inadequate to the immediate challenges in Europe's neighbourhood as largely irrelevant to them. It is a policy for the world as we would like it to be, not as it currently is. Viewed as a toolbox, it offers some useful instruments. But it is not, and cannot be, the principal vehicle for Europe's dealings with its near abroad"<sup>3</sup>.

In fact the Ukrainian crisis has already made and will add significant adjustments to the policy of the Eastern Partnership. On the one hand, there are ongoing efforts to convince in fundamentally unchanging substance of the EaP, and on the other – realities and future prospects call for serious rethinking of the tasks and priorities of this program.

### *The need for a new foreign policy strategy of the EU*

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<sup>2</sup> With the exception of the sentence regarding gas talks with Ukraine in the Riga Declaration.

<sup>3</sup> Susi Dennison, Nick Whitney. Europe's Neighbourhood: Crisis as the New Normal. - European Council on Foreign Relations, June 23, 2015; [http://www.ecfr.eu/page/-/Europes\\_Neighbourhood.pdf](http://www.ecfr.eu/page/-/Europes_Neighbourhood.pdf)

The efficiency and placement of appropriate priorities within the EaP are directly linked to the necessity of a foreign strategy renewal for the European Union. This call is voiced by the majority of experts, trying to understand the fate of the ENP and the EaP. In their opinion special attention of a new strategy should be paid to the area east of the borders of the Union, especially, because the situation there is already affecting the position of the EU in the world as well as relationships with many countries.

The conflict around Ukraine and the deterioration of relations with Moscow undoubtedly hamper the formation of such strategy. The course of events in the direction of either escalation of tension or conflict resolution surely affects the determination of a clearer political line in the foreseeable future.

The Ukrainian crisis and its global echoes have coincided with significant strengthening of intentions in Brussels to put its foreign policy in order with no further delays.

In view of the needs to have a new EU strategy in the world and of the emerging leading position of Germany in the Union, many politicians and experts consider it useful to define German foreign policy as clearly as possible. This would greatly contribute to developing new EU foreign long-term policy. It should be reminded that after the end of the World War II, Berlin, on the contrary, was requested not to particularly bother with a clearer and ambitious foreign policy.

Under internal and external pressure after the parliamentary elections in the autumn of 2013 and establishing of a government coalition, Berlin decided to develop this policy format. The new Minister of Foreign Affairs Frank-Walter Steinmeier openly outlined the schedule: its main burden fell on 2014. Probing public opinion on the subject of readiness of Germans to take additional commitments on international scene was seen as a key component - with, if possible, the enlargement of a public support for a more vigorous foreign policy. The elites at the time had already in principle agreed on the need of such a policy. But the conflict have introduced its corrections in the Minister's plans.

As for the EU foreign policy, since the early 2010s analysts have started with much greater attention to develop the long-term (up to 2030) scenarios of the global and regional trends, linking them with strategic joint EU policy. It seems that the bulk of work was done just on the eve of the Ukrainian crisis. But new serious challenges have demanded modifications and additional efforts in this endeavour.

German emerging leadership is a positive factor for Russia, despite the tough stance of Berlin on Ukraine. In the European explorations, aimed at the developing of a common foreign policy, considerable attention is paid to the elimination of the current negative trends in the relations with Moscow. With different nuances the task to re-engage both parties in a strategic dialogue is set. One of the significant messages to start such a process appears to be a search for solutions in trade and economic areas, even despite the sanctions' regime.

As noted by Steven Blockmans of Brussels Centre for European Policy Studies already at the end of last year, “Given Russia’s negative inclination to the EaP, the EU needs to coordinate its policy towards its Eastern partners with that towards Russia... This requires that: firstly the EU formulates a new strategy towards Russia; secondly EU-Russia strategic summit meetings are at one point re-instated and provided with real content; thirdly greater regulatory convergence is ensured between the AA/DCFTAs<sup>4</sup> and Eurasian Economic Union regulations”<sup>5</sup>. However in view of the work on the EU common strategy it is logical to include the development of strategy for Russia into it, what, in turn, may impact on the future vision of the EaP in Brussels.

## **UKRAINE**

Official Kiev does not conceal the extreme seriousness of the current economic turmoil. According to it, during last year the GDP fell by 7% (whereas during the fourth quarter by almost 15%). For 2015 three scenarios of further reduction have been presented - by 5.5%, 8.6% and 11.9%, with the inflation rate from 27% to 43% (in addition just in April the year over year consumer price inflation increased by 61%, while the take-home wages reduced by 24%).

Before obtaining the decision of the International Monetary Fund (IMF) on the next tranche in March 2015 the foreign exchange reserves amounted to only \$ 5 billion. Half of the March tranche was then used for their increase and at the beginning of June they remained stable, reaching nearly \$ 10 billion.

As analysts of the Eurasian Development Bank presumed in June 2015, “a reduction may be expected in the scale of recession in the second half of the year... Nevertheless the fact that the fall in GDP in the current year is largely related to the effect of armed hostilities in the east of the country, rather than to various economic factors, means that in the absence of settlement of the conflict the parameters of recession will remain significant until the end of the year. Under these conditions GDP could fall by more than 10% according to the results of 2015”<sup>6</sup>.

According to the figure of speech of the Ukrainian Minister of Finance Natalia Yaresko, shared on April 17, 2015 at the US Peterson Institute, the country is in a state of “trauma”, from which it must be recovered in order to make the second step - of “getting the patient to the feet”. The third step would be to provide the patient with the ability to “run”. The IMF tranche, in her view, allows to “get rid of the trauma”.

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<sup>4</sup> DCFTA - Deep and Comprehensive Free Trade Area (see more about this form of economic integration of the EU with its partners in the above-mentioned work by INSOR).

<sup>5</sup> Steven Blockmans. Seven challenges to the Eastern Partnership. - Centre for European Policy Studies, November 14, 2014; <http://www.ceps.eu/blog-posts/seven-challenges-eastern-partnership>

<sup>6</sup> CIS Macromonitor. June 2015 / Eurasian Development Bank. Research Department; [http://www.eabr.org/general/upload/MM\\_CIS\\_2015-06-25.pdf](http://www.eabr.org/general/upload/MM_CIS_2015-06-25.pdf)

In June 2015 in the Marshall Fund in Washington, the second person of IMF D. Lipton replied to the question on the feasibility of creating a “Marshall Plan” for Ukraine that “in a sense a plan does exist” specifically in the form of an IMF lending program. According to him, it is comparable with this plan, if comparing it to the GDP of the recipient country. In this regard, he noted that “both Russia and Ukraine are also our members. All of us jointly, members of the organization, are trying to help Ukraine. We wish Russia to be part of this effort”<sup>7</sup>.

This is in reference to the agreement with the Fund on provision of \$ 17.5 billion over the period of four years, which allows to rely upon an additional \$ 7.5 billion in multilateral and bilateral aid from other sources (such as the World Bank, the European Bank for Reconstruction and Development, from the European Union and the United States). Financial assistance is determined by a number of demands, including those of a reformist character, which for Kiev are extremely difficult to accomplish in the proposed timeframe. Even upon their adoption it appears that Ukraine would lack \$ 15 billion in order to reach the declared necessary volume of \$ 40 billion for the period of 2015 to 2018.

So far negotiations are being carried out with the debt holders in order to achieve write-offs amounting to 40% of the debt and to find the remaining billions by reducing domestic funding needs. However, even if this problem is resolved, the volume saved would not suffice even for the emergency needs of Ukraine. This is being recognized not only by experts, but also by officials of high rank in the EU, such as the deputy-head of the European Committee on Budgets Kristalina Georgieva.

According to the official conclusion of Kiev, made in May 2015, during the next four-year period the total amount of payments on external and domestic debt will amount to \$ 47 billion (of which \$ 30 billion is constituted by external debt). At the time, the total amount of public and government-backed debt amounted to approximately 70 billion dollars.

Of these, the one to Russia accounted for nearly \$ 4 billion – \$ 3 billion of government debt in Eurobonds and nearly \$ 1 billion government-backed debt to four leading Russian banks. In total, Ukrainian borrowers owe these banks approximately \$ 30 billion.

Allocations from the outside are required both for modernization of the economy and for costly major actions on the approximation of technical standards with the EU and the numerous measures of a regulatory nature pursuant to the AA. Currently, while the attention of politicians and experts is directed mainly towards negotiations with international organizations and the restructuring of the Ukrainian debt, there is no time to remember the huge attendant costs, including for businesses, which in the future will be compelled to rebuild production according to European standards.

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<sup>7</sup> Quoted according to TASS statement, June 10, 2015; <http://tass.ru/mezhdunarodnaya-panorama/2031610>

According to the reports from news agencies of January 1, 2015, the Prime Minister Arseniy Yatsenyuk acknowledged that he did not expect any private investors this year and hoped, as he put it, for the international financial institutions as “first-movers”.

In mid-May 2015 the State Statistics Committee of Ukraine refreshed data on direct foreign investments (FDI) in the country. As of April 1, the share capital of non-residents amounted to 41 billion USD, which is by 10% less than at the beginning of the year. The data of the State Statistics Committee are confirmed by the Vienna Institute for International Economic Studies: FDI has decreased from 3.4 billion Euros in 2013 in the next year as much as tenfold, to 309 million. We may add to these calculations the recognition of the Ministry of Economic and Trade Development of Ukraine that in May 2015 the influx of FDI reached the lowest level in the history of recent times. Thus, the year after the signing of the AA between the EU and Kiev has cast serious doubt on the calculations for one of the pillars of the implementation of the Agreement. A huge problem has emerged with the influx of FDI.

It may continue to worsen in the event of defaulting by Kiev. Even with all the possibilities of “debottlenecking” of this situation, the interest of private investors in the Ukrainian market will inevitably fall even further, thus increasing the burden on the international and national structures of the leading countries.

The enthusiasm of foreign, especially private lenders is constrained not only by the risks associated with conflict. The current leadership has inherited all-encompassing corruption. In the global ranking of corruption by “Transparency International” Ukraine ranked 142nd in 2014 (in the list of 175 countries).

The task of overcoming the over-regulation of economy is linked to this problem. The authorities of Kiev have drawn up an annual plan of 171 initiatives in this area. However it should not be forgotten that Ukraine presently occupies the 96th place in the world ranking of attractiveness for doing business. With all the motions it will take lots of time for the investors to begin investing seriously.

Let us briefly address the report of the Vienna Institute for International Economic Studies “How to stabilize the economy of Ukraine” (April 2015)<sup>8</sup>. The authors deliberately distance themselves from political themes. Let us single out some scenarios and recommendations proposed by them with our concise comments.

Even in the scenario of maintaining the cease-fire (at the time of the release of the material) economic recovery cannot be expected to start before 2017. Economic stabilization and return to economic growth are not possible without the settlement of the military conflict. The latter should be a top priority for policy makers. In fact, this fits into the logic of presentation of tasks and concerns in the final declaration of Riga EaP summit.

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<sup>8</sup> “How to Stabilise the Economy of Ukraine” / The Vienna Institute for International Economic Studies, April 2015; <http://www.wiiw.ac.at/how-to-stabilise-the-economy-of-ukraine-dlp-3562.pdf>

For industries that are highly sensitive to the technical standards required by the European Union and to adaptation to market conditions (mechanical engineering, railways, chemical industry, nuclear energy, etc.), a longer transition period than the one set out in the AA is necessary to perform the prescribed regulatory requirements. This in turn, logically, requires regular negotiations and consultations. By the way, this objective reality was ignored by the summit in Riga, even though Brussels will still have to take it into account - publicly or covertly.

Industrial policy should recognize the new reality. The “industrial heartland” of the Ukrainian economy is mainly in the east, where the traditional commercial and production ties used to lead primarily to Russia.

In the mentioned INSOR report we also warned about threats of forced migration of citizens of Ukraine both to the east and the west. Compared with January 2014, in June 2015 the number of Ukrainians in Russia has increased by nearly 950 thousand – from slightly more than half a million to 2 million 504 thousand. From January 2014 to May 2015 Russia spent on the Ukrainian refugees and temporary migrants over 11 billion roubles<sup>9</sup>.

## **RUSSIA**

### *Foreign trade*

Despite the current crack at the borders with the European Union and bridging the Far Eastern borders, Russia is objectively interested in large-scale and close economic ties with the European Union and non-Union European countries. It is not surprising that even with the current cooled background this is insistently repeated by Moscow representatives of the highest ranking.

EU ranks first in Russia's foreign trade turnover (almost 103 billion Euros in imports and 207 billion in exports), followed far behind by China (with the volume of Russian procurement of almost 41 billion Euros and deliveries of no less than 27 billion Euros).

In respect to the Russian imports these are followed by the United States and Ukraine (by more than 12 billion Euros each), Belarus and Japan, with a considerable margin as well - South Korea, Turkey, Kazakhstan and Brazil. In respect to exports - Turkey (20 billion Euros), Ukraine (more than 18 billion), Belarus (15.5 billion), Japan (over 15 billion), Kazakhstan (13.5 billion), South Korea (11.4 billion) as well as the United States and Switzerland.

In general, it turns out that by 2015 the EU accounted for almost 50% of Russia's foreign trade turnover against China with 10.5% and Ukraine with 4.7%. Further down the list are Belarus, Japan, Turkey, the United States, South Korea, Kazakhstan and Switzerland.

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<sup>9</sup> Мария Жолобова, Максим Солопов. Цена побега. — «РБК», June 23, 2015



With minor alterations in the alignment of partners, a marked decrease in the Russian foreign trade turnover took place - by 34% in January 2015 compared to January of the previous year. Imports decreased by 41% and exports - by 29%. At that a more significant reduction affected not the Western countries, but the CIS countries (including Ukraine) – by 42%. Among the reasons there is not only to the decrease in prices, but also the slowdown in the economy and production of these countries.

The structure of Russian exports to this region has undergone certain alterations. The share of energy products has decreased from almost 60% in January 2014 to 53%, while the share of machinery and equipment - from 10.4% to 8.5%. In the imports from CIS countries deliveries of machinery and equipment have also decreased to 20%, as well as of agricultural products (to 17.2%).

### *Sanctions*

The European Union sanctions have blocked access of Russian banks and companies to the European lending capital market. Oil and gas companies are moved away from the modern equipment, the defence industry - from advanced technologies. Retaliatory sanctions of Russia have led to the closure of the market for agricultural producers from the EU causing accompanying costs.

At the end of 2014 the experts of Vienna Institute for International Economic Studies shared preliminary calculations of the cost of such actions and reactions to the EU member states. In case of reduction of exports of goods and services from the EU to Russia, Lithuania may lose approximately 0.5% of the GDP, Estonia - 0.4%, Austria - 0.1%. The losses of Germany amount to 3 billion Euros, of Italy – to 1.4 billion Euros, of France and Poland - 800 million Euros, and of Austria - 300 million Euros. The embargo of Russia on food products, the amount of exports of which is calculated at 5 billion Euros, to a larger extent is related to Lithuania, Poland, Germany and the Netherlands, as well as Austria, which in 2013 accounted for exports of 100 million Euros in goods presently banned for importing.

Alongside with this, the authors of the prospects estimate that a further spiralling of penalties will significantly increase the level of costs. As evidence of that, in April 2015 they estimated the total loss to the EU at 100 billion Euros.

In the course of preservation of sanctions new cost estimates for Russia and the initiators of those sanctions are gradually emerging. These estimates directly relate to the introduced regime or are presented within the totality of the emerging difficulties encountered by Moscow.

According to the statement of the Minister of Finance of Russia Anton Siluanov made at the end of January 2015, as a result of the combined effects of sanctions and falling oil prices (from 100 to 50 dollars per barrel), the Russian economy lost at least \$ 200 billion last year or “probably a little more”. Of these, capital deficit due to the sanctions amounted to \$ 40 -50 billion.

In April 2015 President Vladimir Putin evaluated these combined results at 160 billion dollars. At the same time the Prime Minister Dmitry Medvedev, estimating only the costs in the first quarter at 25 billion Euros (he nevertheless attributed this evaluation to “foreign experts”), prospected losses from sanctions in 2015 to constitute 75 billion Euros, or 4.8% of the GDP.

Aimed at the Russian defence industry and oil and gas sector, the sanctions are designed not for fast, but for long-term effect. Certain dependence of the defence industry on the import of components will not yield effect quickly, at least due to the existing stocks. Taking into account the information protection it is difficult to calculate the timing of the emerging of critical issues in the various sectors of the industry.

The effect of the financial sanctions however is already noticeable. Without former possibilities of external borrowing, Russian banks and companies only in the fourth quarter of 2014 were compelled to spend huge amounts - 10% of the GDP. In 2015, the amount of payments is expected to constitute 5% of the GDP, and in 2016 - 3%. For the three quarters of sanctions since mid 2014 the Russian businesses had to return to their Western partners more than 170 billion dollars without adequate access to new loans.

This seriously affects the economic development plans, since a large share of the funds is spent to cover debts.

Alongside with this, the financial sanctions of the EU are broader than it may seem when reading the adopted documents. For example, they may be applied not only to the Russian state-owned companies from the sanctions list and subsidiaries controlled by them, but also to companies in the capital of which they participate and, therefore, have an impact on them.

EU sanctions reformat and inhibit the tried and tested procedures for the technical execution of transactions; control is enhanced over payments of the companies from the sanctions list. Hidden risks are increasing, especially for companies with significant state participation share. This pertains to the servicing of loans obtained by the Russian banks, as well as the capital borrowed by oil exporters on foreign markets. Difficulties with external funding have significantly impacted the reduction of foreign currency inflows and the increase in interest rates, which, in turn, reduced the quality of loan portfolios, pushing up non-performing loans of Russian banks and shortage of dollar liquidity, contributed to the devaluation of the rouble and the expansion of capital outflows abroad.

The outflow of capital constitutes one of the important factors of the overall decrease in investment attractiveness of Russia. Assets are moved out not only by the Russian business, but also by foreign investors. Sanctions have a much greater impact indirectly. The authoritative Association of European Businesses in June 2015 conducted a survey of European companies in Russia, of which only 5% are directly

affected by the sanctions regime, and 16% - partly. However the negative effect of sanctions was felt by 38% of the companies.

Top managers have become more pessimistic about the prospects both of their own businesses and the economic development of Russia. Moreover, even the improvement of the Russian positions in the ranking of Doing Business (62nd place) turned out to be unnoticed by 86% of the respondents. Among the main obstacles to the development of business, in spite of the sanctions, regulatory restrictions and lack of qualified personnel are still in the lead. Record high number of participants in the history of research expected decrease in the investment activity, the share of their opponents decreased in the first quarter of 2015 to 23% against 31% at the beginning of 2014, 59% in 2013 and 70% in 2012. However, in the long- term perspective (6 - 10 years), 73% expect economic growth in Russia. It should be noted that AEB surveys are a kind of a benchmark for attitudes of companies working with direct foreign investment (rather than speculative capital).

In general, financial sanctions increase the threat of the unwinding of the inflation- devaluation spiral. The struggle with this under the sanctions background brings to the fore the problem of transition to a new model of economic development, to the growth of production and its efficiency, to partial import substitution policy.

Some of the leading European banks are suffering from this kind of sanctions. The portfolio of European lenders contains liabilities for nearly \$ 150 billion. In this respect France with 44 billion dollars is in the leading position. It is followed by Italian banks (27 bln. dollars), Germany (17 bln. dollars) and Britain (15 billion dollars).

A particularly painful blow is dealt by the sanctions and the general cooling of the climate to investment activity. According to the Central Bank of Russia, in 2014 FDI into Russia amounted to approximately \$ 21 billion against almost \$ 70 billion in 2013. FDI declined also during the crisis at the end of the 2000-2009 period, but then the decline was only two-fold - from 75 billion dollars in 2008 to 36.6 billion dollars in 2009.

The sanctions also negatively affect the operation of the EEU. They have already affected the consistency of trade policies of the member countries. Introduction of “counter-sanctions” by Russia without the approval of such measures by Belarus and Kazakhstan has led to noticeable friction with Moscow. They have affected the functioning of the common customs territory, because the goods crossing the external border of the Union can easily be moved inside it. The risk of re-exports of goods, particularly through Belarus, arise and increase, also for those groups, analogues of which are produced in Belarus itself.

In the long term the Russian embargos will find themselves in obvious contradiction with the declared principles of the EEU common market. This would not happen only in cases of accession of partners to counter-sanctions or cancellation of those counter-sanctions.

## **RUSSIA – UKRAINE – THE EU**

### *The trilateral format*

Let us return to the report of Vienna Institute for International Economic Research. According to the authors, the European Union and Ukraine should adopt a more constructive stance in respect to Russia's concerns related to the implementation of the AA. Trilateral talks focusing on trade issues, on the preservation of the preferential regime for Ukraine in the framework of the CIS Free Trade Agreement (a party to which Kiev still is) should be stepped up. This agreement remains a real foundation for reaching optimum consensus.

INSOR introduced such a proposal already in May 2014 during “the Baltic Forum” and in the report in June of the same year.

Trilateral talks concerning combining by Kiev of the participant status of the free trade area (FTA) with the CIS and the EU were held in July and September, 2014. In September, it was possible to negotiate the suspension of action regarding the economic part of the AA between Ukraine and the EU (which sets out the obligations under the FTA) until the end of 2015.

In his article “Russia and Ukraine: Life under the New Regulations” (“Nezavisimaya Gazeta” of December 15, 2014) the Prime Minister of Russia Dmitry Medvedev shared the following observations: “Even to the new Ukrainian authorities succeeding Yanukovych it has become apparent that ignoring the position of Russia is no longer possible. Otherwise, in July this year in Brussels tripartite talks between Ukraine, Russia and the EU on issues related to the association would not have been held, and in September the parties would not have agreed that certain provisions of the Agreement will not be introduced before 2016. However between refusal and consent to discuss these issues a dramatic chain of events has taken place”.

After the talks in July and September of 2014 Brussels slowed down its work and the next round was held only in May 2015. At that overall fundamental obstacles (if we abstract from the general background), which would interfere with the agreements relating to the implementation of the economic part of the AA do not exist.

As recognized in the Joint trilateral statement on the results of the tripartite meeting of May 18, 2015 “some issues can be resolved on the basis of flexibilities envisaged by the provisions of a deep and comprehensive free trade area, while others - under the current bilateral or trilateral and multilateral cooperation”. In other words, the existing legal instruments allow finding a “niche” for the removal of mutual concerns, as mentioned in the reports of the Institute for Contemporary Development.

What then is on the agenda in order to meet the concerns of Moscow? This is in reference to maintaining and improving mechanisms for the exchange of customs data and electronic verification of the origin of goods. This requires strengthening of

customs cooperation, including the ensuring of compatibility between the systems of processing and storage of customs information. This also includes combating fraud and the willingness of Russia and Ukraine to review the regulation on the origin of goods in the framework of the Agreement on the CIS FTA. The possibility of concluding an updated agreement between Moscow and Kiev in respect to mutual recognition of veterinary certificates and the extension of transitional periods on regulatory obligations, where appropriate, by using the “flexibility” provisions of DCFTA in the AA should not be excluded. Finally, there is the task to continue the process of harmonization in order to minimize the effects of alterations in the technical regulation.

In the absence of significant barriers of procedural and technical nature failures of this format may be caused primarily by political motives. Most likely, the latter will continue to prevail.

At the beginning of July 2015 another round of expert consultations for the preparation of the ministerial meeting in the trilateral format postponed for September was held. However, no positive outcomes may be observed so far.

In the case of a probable refusal for prolongation by Kiev, Ukraine may be withdrawn from the Treaty on CIS free trade area with tangible losses both for Ukraine and for the European Union. The latter will have to seek additional resources to assist Ukraine in mere survival in socio-economic terms.

One of the main consequences of failure in the work in this format is that it may intervene with the development of a common platform for wider areas, basically in respect to the main track of Russia – EU, first of all in respect to attempts of aligning the European and the Eurasian projects in their trade and economic part.

### *The EEU and the EU*

The fate of the tripartite negotiations, apparently, may serve as an important sign of the willingness to discuss wider agreements that would permit returning to the originally stated objectives of the European Neighbourhood Policy and the EaP. Let us recall that they were aimed at a stable and prosperous neighbourhood of the EU to the east of its borders.

Intensification of contacts between the EU and the EEU, between the European Commission and the Eurasian Economic Commission (EEC) could serve as another, even more important evidence of such willingness.

In the second half of January 2015, three events coincided. During Davos forum kantslerin of Germany Angela Merkel announced the possibility of a dialogue between the EU and the EEU. A day later, after a meeting with the Prime Minister of Italy, she once again drew attention to the fact that “in its complex overcoming of problems with Russia depends on the process of Ukrainian reconciliation. Between the EU and the newly established Eurasian Union it is possible to conduct a dialogue

on economic and trade issues”. She also pointed to the need of finding solutions for the “removal of trade barriers” (TASS, January 23, 2015).

At the end of November 2014 she already noted the willingness “to discuss trade issues between the Eurasian Union and the European Union”. In January it may be observed that the themes expanded on behalf of economic problems. Also in November, the head of the Ministry of Economic Development of Russia Alexei Ulyukayev informed that his office had submitted a letter to the European Commission with a proposal to launch a new dialogue between the EEU and the EU on economics and business partnership. Shortly before, the first significant contacts between the European Commission and the EEU took place.

At the end of 2014 the deputy Foreign Minister of Russia Vasily Nebenzya in an interview for TASS identified as a long-term objective for cooperation between the European Union and the EEU establishing of a free trade area as the foundation for joint economic space from Lisbon to Vladivostok, which was mentioned by the President of Russia Vladimir Putin at the last EU-Russia summit in January of the same year. Vasily Nebenzya added: “We welcome the recent statements by a number of European politicians on their support for direct dialogue between the European Union and the EEU”<sup>10</sup>.

The second January event was the press conference of the Foreign Minister of Russia Sergei Lavrov on the results of Russian diplomacy in 2014. He remarked, speaking of the interest in developing cooperation with the EU: “This is not the first year that we call upon the partners to start substantive work on the project “integration of integrations”, referring to the sequencing of steps to create a common economic and human space from the Atlantic to the Urals ... The first step on this road could be the launch of negotiations on agreement on a free trade zone between the EEU and the EU ...”<sup>11</sup>.

On January 19 a meeting of the foreign ministers of the EU countries to discuss relations with Russia was held. The EU High Representative for Foreign Affairs and Security Policy Frederica Mogherini prepared a confidential paper, which came into the disposal of the British newspaper “The Financial Times”. Let us cite the passage of the document we are interested in.

“Recently, some level of engagement with the Eurasian Economic Union has been suggested. Eurasian integration is a major foreign policy initiative and priority of Russia, but also has a direct impact on the scope of the EU’s economic relations with Russia’s integration partners, such as Kazakhstan, Belarus and Armenia ... While recalling the EU’s and Russia’s shared objective of creating a common economic space “from Lisbon to Vladivostok” the question arises how best to promote such a

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<sup>10</sup> Vasily Nebenzya: “Integration is a living process”. - TASS, December 31, 2014 .; <http://itar-tass.com/opinions/interviews/1682103>

<sup>11</sup> Remarks and Response to Media Questions by Russian Foreign Minister Sergey Lavrov at the annual press conference on the results of Russian diplomacy in 2014 in Moscow on January 21, 2015; [http://www.mid.ru/brp\\_4.nsf/0/6631F30FBE1AB4B643257DD4003D0D59](http://www.mid.ru/brp_4.nsf/0/6631F30FBE1AB4B643257DD4003D0D59)

vision, whether through the establishment of ties between the EU and the EEU or a set of other bilateral and/or multilateral agreements? In this respect, a number of determining factors should play a role, such as Eastern Partnership countries' approach to this question and trade issues currently challenging EU-Russia bilateral trade relations ... Possible step for consideration: launch of an internal study, analysing options and limitations for different EU trade relations with Russia and the wider region, taking into account their political and economic implications, including an assessment of the implications of a possible establishment of relations with the EEU?"<sup>12</sup>

In case of a positive response to this question the findings of the study naturally depend on the degree of resolution of many other problems, primarily of a non-economic character. Logically, that in the cited passage of Frederica Mogherini paper a whole range of issues is inscribed on which certain guidelines for solutions have been determined. Namely, the conflict in Ukraine, serious challenges to European security, attempts to figure out the "true intentions of the Kremlin" in this conflict and so on.

Specifically these challenges primarily occupy the minds of European politicians and experts, and therefore they in particular have been at the forefront for the critics of Frederica Mogherini paper, who has been accused of "a too gentle attitude" towards Moscow. Interestingly, however, that even in this offensive her passage cited above of economic character is either ignored or has evoked certain understanding.

The main message of the evaluations is uncertainty of what is meant by dialogue. In response to the document the expert of the European Council on Foreign Relations Kadri Liik, while listing its strengths and weaknesses, notes: "Talks between the EU and EEU are proposed these days by many in Europe as a potential basis for a new "grand bargain". But it remains unclear what the talks would actually achieve."<sup>13</sup>

The High Representative however has made an attempt to pose this problem and most importantly - to give an official impetus to expert developments. Without this, reluctance or simple opposition to the project by a number of countries will continue to be veiled under the wording of "a misunderstanding". There are proponents and opponents of trade and economic interaction of the EU with the EEU. As of the time of publication of the paper the first group included Germany, France, Italy, Spain, Austria, Hungary, the Czech Republic, Slovakia, Greece and several

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<sup>12</sup> Issue Paper on Relations with Russia. Foreign Affairs Council of January 19, 2015; <http://blogs.ft.com/brusselsblog/files/2015/01/Russia.pdf>

<sup>13</sup> Kadri Liik. The real problem with Mogherini's Russia paper. - European Council on Foreign Relations, January 20, 2015

other countries<sup>14</sup>. The rest considered rapprochement premature or even useless, offering to overcome the conflict in other areas of possible compromise. But, again, Frederica Mogherini elaborated on these areas, inscribing into the document the target setting for interaction with the EEU.

In the widely commented article “The New European Mess” renowned experts Ivan Krastev and Mark Leonard (Russian translation, in the newspaper “Vedomosti” of December 17, 2014) have rather frankly stated: “If the EU opens for themselves the prospect of rapprochement with the EEU, Russia will be sent a clear signal that Brussels recognizes its right to its own integration process. The willingness of the EU to recognize the “Eurasian choice” of Armenia will enable Brussels to legitimately compel Russia to recognize the legitimacy of the “European choice” of Moldova and Ukraine. Russia has dispelled the European dreams of a future in which the postmodern EU island stretches across the entire continent ... Today, the time has come for the EU, in turn, to be aware of the harsh reality. Europe needs to focus transformation efforts on consolidating its own political space, which now also includes Ukraine and Moldova and to acknowledge the existence of the real world beyond its borders”.

In the report of the Directorate-General for Foreign Policy of the European Parliament<sup>15</sup> (March 2015) three scenarios of “coupling” of the two projects for the signatories of AA are offered. The first scenario proposes maintaining the current *status quo* and the implementation of the current course. In this case, Moscow's reaction in the set of measures - ranging from the removal of preferences under the Agreement on the CIS FTA to restrictions on the work of the citizens of Georgia, Moldova and Ukraine together with additional costs for the EU and the IMF will become for these countries more costly in the short-term perspective than even long-term benefits of trade with the EU. This estimate suggests a major adjustment of old views of economists on the benefits and costs of “European choice”. It is true though that their cost calculations are very optimistic, such as, that in case Ukraine leaves the Agreement on the CIS FTA it would lose “only” \$ 3 billion annually.

The second scenario constitutes, namely, elaborating on strengthening the compatibility of DCFTA and the Agreement on the CIS FTA, so that all partners of the AA could quite painlessly remain in both formats. In this case, “no one chooses and thus no one loses”.

This scenario allows participation in the AA (Art. 39 of the AA with Ukraine, Art. 36 of the AA with Georgia and Art. 157 of the AA with Moldova) - as well as the Agreement on the CIS FTA (Art.18). In its implementation however, the report states, there are complexities of technical and political character. For technical complexities

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<sup>14</sup> In: E. Chernenko. The EU will try to approach Russia on good terms. Brussels develop a new strategy for relations with Moscow. – “Kommersant”, № 6, January 19, 2015 .; <http://www.kommersant.ru/doc/2649341>

<sup>15</sup> The Eastern Partnership after five years: Time for Deep Rethinking / Directorate-General for External Policies. Policy Department; [http://www.europarl.europa.eu/RegData/etudes/STUD/2015/536438/EXPO\\_STU\(2015\)536438\\_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/STUD/2015/536438/EXPO_STU(2015)536438_EN.pdf)



addresses the compatibility of standards, but this issue can be resolved at the negotiation table. Less predictable terms are stipulated by political motives of all parties. At that it should be noted that the Russian Ministry of Economic Development has already given positive signals in favour of such a scenario. “Provided the political and technical concerns shall be removed, the trade negotiations can be designed to meet multiple needs”.

The third scenario is far-reaching - going beyond the frameworks of the two FTAs and working towards establishing of a real partnership between the two areas – the EU and the EEU. In this scenario, the participants of the AAs will not choose a program of one or the other project and moving in the direction of one of them *de facto* would mean moving towards the other.

Much depends, according to the report, on the standpoint of Russia. “The economic, political and military surprises of the last 16 months have elicited a need for the EU and its AA partners to take into account concerns of Russia as partners who are moving towards a rapprochement”. The report acknowledges that the presented “analysis of trade and economic issues does not offer a definitive answer for the leaders on how to proceed ... but provides them with an extra material for consideration in their steps forward ...”.

Opponents and even supporters of the interaction between the EEU and the European Union single out complexities in the establishing of the Eurasian economic project. Indeed, many of the questions regarding this new formation have not yet been resolved, be it the development of the joint monetary and fiscal policy or energy supply trade.

However, the institutions of international integration have started to function not on paper, but in fact. With the status of a supranational governing body, EEC coordinates about 170 functions of the Union. On the supranational level trade policy has been submitted to the Commission and its decisions have to be carried out in the entire area of the Customs Union. Thus, part of the economic sovereignty of the EEU members has been transferred to supranational structures. External partners have to and will have to deal with this reality.

It should be noted that in the text of the EEU agreement all the provisions relating to political integration (foreign and military-technical policy, common citizenship, common border security, and so on) have not been included. Provision on the right of Russia to protect the interests of its compatriots in other countries has been deleted. In fact, this entails an economic union, what is perceived, especially by the critics of the EU cooperation with the EEU, with a great deal of scepticism. Another thing is that in this formation Russia according to its economic weight is clearly dominant.

Naturally, there exists mutual distrust in respect to both projects. In the editorial in “Nezavisimaya Gazeta” the following is frankly stated: “The European Union is a historically unprecedented project, whereas the integration process with the centre in

Moscow reminds Western Europe of the Soviet Union, which for decades was perceived as enemy. Any movement toward the reintegration of the post-Soviet space evokes understandable distrust and fear in the Europeans and Russia is doing nothing in order to dispel this fear. On the contrary, in Russia it is considered to be the appropriate to take pride in the Soviet past and “the times when everyone was afraid of us”<sup>16</sup>.

The need to remove such biases, however, does not cancel in the least the big challenges for the harmonization of the two integration projects and joint support to the Ukrainian economy, which have been discussed above and the decisions in this respect will inevitably be based on the existing and emerging institutions of European and Eurasian integration.

The last meetings on high level of expertise with representatives of Russia, indicate that despite different, sometimes radically opposed assessments of what is happening, all agree that distancing of Europe and Russia does not meet the long-term interests of either side. Specifically the preparation of the interaction of the EEU and the EU on Ukraine's economic recovery could turn confrontation into cooperation. Joint operation of the two organizations with subsequent involvement of the US and China in the resolution of this task constitutes the most favourable way out of the present circumstances.

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<sup>16</sup> Why Europeans do not accept the vision of Putin - «Nezavisimaya Gazeta» June 9, 2015; [http://www.ng.ru/editorial/2015-06-09/2\\_red.html](http://www.ng.ru/editorial/2015-06-09/2_red.html)