

POLITICO-ECONOMIC RESULTS IN MAY 2014

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Tensions in the eastern Ukraine were eased a bit in May 2014, although the causes of the conflict still remain to be resolved. There is a fragile balance today between the Ukrainian military forces and the armed groups of supporters of federalism in Donetsk and Lugansk regions. In the circumstances, Russian leaders made a few conciliatory statements, making it clear that Russia is ready for a dialogue with Ukrainian President P. Poroshenko elected on May 25, 2014. Beside the military issues, there is a serious Russia-Ukraine conflict over payments for Russia's natural gas supplies to Ukraine. Russia entered into a contract with China on large supplies of natural gas in the long-run perspective. The profitability of the contract remains questionable due to the need to build from scratch a new pipeline, however, Russia seems to be seriously interested in China's potential to finance, even now, the Russian economy. The anticipated Treaty on the Establishment of the Eurasian Economic Community covering Russia, Kazakhstan and Belarus was signed, without causing any sensations. Russia made minor concessions but gained its principal point on the impropriety of nulling export duties on hydrocarbons in trade relations between the countries.

According to the data available on Ukraine, a military parity was established in May 2014 between Ukrainian military forces loyal to the Kiev government and federalization supporters who control most of the territory in Donetsk and Lugansk regions. None of them can progress substantially despite regular clashes using heavy weapons. Russia left without response the federalization supporters' appeals for sending Russian troops to Donetsk and Lugansk regions, however, the federalization supporters themselves admit that the bulk of their armed groups consists of volunteers from Russia, in particular from Chechnya and Ossetia. At the same time, President Putin stated on May 7 that the upcoming May 25 presidential election in Ukraine is "a step in the right direction" and he is "ready to work" with those who will take office in the Ukrainian government after the election. Entrepreneur P. Poroshenko was elected Ukraine's President in the first round (53% of votes). His Russian assets, a confectionery works in Lipetsk, have been frozen for several months, and Russia's ban on supplies to Russia of products manufactured in his Ukrainian plants has been in force for almost a year. Kremlin hasn't yet sent an official message of congratulations to recently elected President Poroshenko, but there is an indirect evidence of Russia's readiness to deal with him, i.e. there was a message of congratulations from Patriarch Kirill, Head of the Russian Orthodox Church, plus Russian TV channels have stopped covering the topic of "legitimate" President Yanukovich". The United States, Canada, European Union, Australia, and other countries which previously imposed sanctions against Russia, have actually given up new sanctions, saying

that they can be imposed in case of Russian military incursion into the eastern Ukraine.

The existing balance is very delicate. It is absolutely unclear what Russia would do if the self-proclaimed Donetsk and Lugansk People's Republics find themselves to be on the brink of a military defeat and liquidation. Truly, as long as they control their territories, they constitute a more acceptable legal form than direct annexation of these territories by Russian military forces. Apart from the still existing threat of new sanctions against Russia, the country is facing new multi-directional threats – from questionable usefulness of actions such as military coup (if a coup is possible in Donetsk, why it may not be possible in Moscow?) to damages to Russia's image in case of liquidation of the self-proclaimed republics – their supporters would accuse Russia of betrayal, and it would be difficult to defeat such accusations given the tone of news reports in Russian official mass media. Furthermore, there is a very serious gas conflict between Russia and Ukraine. As a reminder, Ukraine is not only a consumer of Russian natural gas (about 25 billion cubic meters at 2013 year-end), but it is also the largest transit country of Russian gas, therefore without using the Ukrainian capacities Russia will not be able to meet its obligations on gas supplies to Europe. Under the Russia-Ukraine gas contract signed as early as 2009, whose terms are very unfavorable for the Ukrainian party, the price of gas is much higher than \$400 per 1000 cubic meters¹ but reduced to a 30% (but not more than \$100 per 1000 cubic meters) as discount for the deployment of Russia's Black Sea Fleet in the Crimea under

¹ The exact price was calculated on a quarterly basis and was, for example, about \$400 USD in 2013.

the agreement of 2010. The Russian leaders believe that the discount has ceased to be in force due to the Crimea's accession to the Russian Federation, whereas the Ukrainian leaders consider the Crimea as Ukrainian territory occupied by Russia, and the discount is therefore still in force. The parties also disagree considerably on proposals of how to address the situation: Russia suggests that Ukraine should redeem at least a part of its outstanding debt owed to Russia, and Russia is ready to discuss further discounts only after the payment is made, whereas Ukraine is not ready to redeem its debt until a new gas supply contract is signed to settle all the disputed issues, Ukraine can pay with the resources received recently as financial aid from the IMF, the World Bank, the United States, and the European Union. The European authorities, on their part, suggest that Russia and Ukraine should switch to direct payment for contracted volumes of gas, so that they can resolve the Russian-Ukrainian dispute. Russia has given no answer yet, threatening to reduce gas supplies to Ukraine if no payment is affected soon.

Therefore, the political component of the conflict has been supplemented with a very significant economic component, and very poor conditions of the Ukrainian armed forces revealed during the clashes with the federalization supporters still may entice Russia to resolve all the problems at once, i.e. by a military incursion. However, the likelihood of tougher sanctions (Russian GDP accounts for mere 3% of the global GDP versus 60% of the countries imposing sanctions), on the one hand, and material financial losses that Russia might sustain in case of assuming responsibility to finance the heavily populated eastern Ukraine (about 7 million in Donetsk and Lugansk regions alone, compared to 2 million or less in the Crimea) and the guerrilla warfare, on the other hand, is what prevents hotheads from doing it. A reasonable option of compromise could become a comprehensive agreement on supplies of not only natural gas but also water, electric power and other commodities, as well as railway transportation to the Crimea, according to the settlement prices which existed prior to the Ukrainian crisis, while politically Ukraine should commit itself to extend the rights of local self-government in Ukraine and provide constitutional guarantees of the Russian language status in the regions where a considerable part of the population speak Russian. As a matter of fact, the selection of terminology isn't so important here. However, this implies inevitable liquidation of the armed federalization supporters for whom this scenario is unacceptable. It appears that Russia, not ruling out a compromise in the economic area, wants to fix the status quo in Ukraine's east regions, i.e. support the

supporters of federalization so that they can survive, while the form of support would be unofficial.

The Treaty on the Establishment of the Eurasian Economic Community covering Russia, Belarus and Kazakhstan was signed on May 29, 2014. Preparation of the Treaty faced difficulties, because Belarus demanded substantial preferences for itself, in particular the introduction of a free trade regime for hydrocarbons, which would mean heavy losses for the Russian federal budget from abolished export duties, while Kazakhstan was against Russia's plans to speed up the accession of Armenia and Kyrgyzstan, especially the latter, to the Community, which would mean lifting barriers to labor force movement in this poor country. Eventually, the status quo was actually fixed: the issue of Armenia and Kyrgyzstan accession were set aside, Belarus increased 20% its quota on duty-free crude oil supplies and received a new loan from Russia, while the issue of abolishing the exclusion of hydrocarbons from free trade was set aside too.

President Putin paid a visit to China on May 20–21, 2014. A few agreements were signed during the visit, in particular a gas supply contract (the respective protocol of intent was signed as early as 2006, but the parties thereto failed to agree on the price) which has been stalled for almost 10 years. The contract covers annual supplies, in the long run, of 38 billion cubic meters of gas at a price near \$350 USD per 1000 cubic meters¹. Neither the volumes nor the price are big. European prices are about \$400 USD, plus there are high-yield markets like in Japan where the price is more than \$500 USD. Russia exported a bit more than 200 billion cubic meters at 2013 year-end. It is important to understand that Russia has failed in attempting to use the so-called "western" corridor via Altai² whereby the existing gas pipeline system could have been used subject to minor adjustments. However, a new gas pipeline to the Kovytkinskoye and Yakut fields has to be build. This means that this contract cannot be a physical alternative to gas supplies to Europe, because in any case it is other gas and other pipeline, but it can, to some extent, be a financial alternative in case Europe reduces purchases of Russian natural gas. Regretfully, many parameters of the contract are confidential; it will take long until it is included into Gazprom's financial statements; its price, according to most experts, is balancing on the brink of profitability; the Russia's federal budget will see no revenues from the mineral extraction tax from

1 Prices in contracts are normally pegged to crude oil prices or other fuel equivalents, which means that the price is not final.

2 China's north-west provinces are underpopulated, industrially undeveloped, and China sees no benefits in building at its own cost a pipeline to eastern China.

which these volumes of gas supplies will be exempted, as was previously announced (Gazprom is very likely to succeed in its attempts to obtain exemption from export duties). While considering eastern sales markets for gas supplies, it would be appropriate to look at more profitable markets of Japan or South Korea, especially because Russia in any case plans to build a LNG terminal in Vladivostok. Beside the gas contract, Russia signed a few other contracts with China, in particular a curious contract on the co-development of a long-haul passenger aircraft, although China shows no technological leadership in this area. A few contracts on the co-development of coal deposits in Russia, supplies of equipment, etc. seem to be quite reasonable. However, few people pay attention a \$500bn loan to Russian corporation Vnesheconombank which is facing refinancing issues after its participation in various Olympic construction projects of the century, and the information on that China may finance the construction of a pipeline. In the meantime, this gives answers to many questions – the Russian economy has been overcredited and, having no good access to western credit resources, Russia has to agree on less beneficial terms of trade with China.

Traditional St. Petersburg International Economic Forum (SPIEF 2014), the largest business forum in Russia, was held in in May 2014. As usual, the Forum became not only a place for the announcement about major contracts, but also for discussions. This acquired a special meaning, because it was actually the first forum of this kind to be held amid a new international situation. In particular, announcement was made about a contract between Total and LUKOIL on the establishment of a joint venture for the development of the so-called Bazhenov Formation¹ in the West Siberia,

¹ Bazhenov Formation is a stratum (set) of rocks discovered in the West Siberian Basin at a depth of more than two kilometers and a territory covering more than 1 million square kilometers. It is heavy saturation with a high-quality crude oil (like Brent oil) that makes it unique and economically valuable.

a gas supply contract between Rosneft and Fortum, a contract between Summa Group and Veliola on the establishment of an operator in the utilities market. Overall, concerns over large businesses' total refusal to cooperate with Russia were not confirmed despite the absence of a few corporate chief executives. The conflict between Russia and Visa and Mastercard which threatened to leave the Russian market because of adopted laws under which they must pay a security deposit much bigger than the profit they generate in Russia was reconciled. There were anxious moments too, e.g. President Putin stated that the Central Bank of Russia will invest in the Russian economy, which basically contradicts the applicable laws and regulations (despite the fact that the Central Bank refinances commercial banks). However, it remains to be seen whether these statements will come into force.

There were a number of shakeups among high-ranking officials in Russia. First of all, resignation of powerful V. Kozhin, former Head of the Presidential Executive Office embracing hundreds of governmental units, and his appointment as assistant to the President, an honorary but symbolic post. He was replaced with little known general A. Kolpakov who previously headed one of the state residencies. N. Rogozhkin appointed the Presidential Plenipotentiary Envoy to the Siberian Federal District, was replaced by Commander-in-Chief of Interior Ministry Troops V. Zolotov who previously headed for a long time the Russian President's Security Service. A. Khloponin was removed from the Presidential Plenipotentiary Envoy to the North Caucasian Federal District but remained in the seat of just a Deputy Prime Minister in the Russian Government, however, close to him L. Kuznetsov, the former Governor of the Krasnoyarsk Territory (Krai), was appointed head of a new Ministry for the Development of the North Caucasus, while Commander-in-Chief of Interior Ministry Troops in the North Caucasus Federal District S. Melikov was appointed presidential plenipotentiary envoy, a less important position, taking account of the establishment of the foregoing Ministry. ●