

POLITICO-ECONOMIC RESULTS IN JUNE 2014

S.Zhavoronkov

The situation in eastern Ukraine and Russian-Ukrainian interstate relations saw a certain de-escalation in June 2014. In particular, Russia recognized new Ukrainian President P. Poroshenko. However, the situation remains to be tense. The east Ukrainian armed groups cannot see how they may exist within a unified state while the government in Kiev cannot allow a secession of these regions. The Russian government authorities are looking for a way out of the crisis, without losing face, but it hasn't been found yet. At the same time, gas price negotiations between Russia and Ukraine reached no agreement. Russia announced transitioning to prepayment for natural gas supplies to Ukraine. Considering gas volumes accumulated by Ukraine, negotiations on this subject-matter are likely to become more relevant in the upcoming fall. Ukraine cannot be excluded from Russia's natural gas transit, at the same time it won't be able to strike its fuel balance alone, without Russia. A fierce dispute on what should be done with the 2014 pension accruals, virtually pension savings as such, began in the Russian Government. The standards of potential infrastructural costs of the National Wealth Fund (NWF) were increased, however, new costs still remain to be agreed.

In June 2014 the Russian government authorities made some changes to their viewing the events in Ukraine. The interstate relations between Moscow and Kiev warmed up a bit. For example, Russia's Ambassador in Ukraine M. Zurabov, who was recalled in February 2014 after President Victor Yanukovich was ousted, returned to Ukraine and attended the inauguration of the new President of Ukraine, which actually implies that Zurabov was diplomatically recognized by Ukraine. However, intensive military clashes using heavy weapons continued in the Donetsk and Lugansk regions between Ukrainian government troops, including the Air Force, and the armed groups from the self-proclaimed republics throughout the major part of the month. Ukrainian government troops recaptured the initiative, succeeding in bringing back under government control the city of Mariupol, an industrial center and seaport, as well as severed lines of communications leading to the Russian border from where the self-proclaimed republics received various types of assistance. At the same time, the Ukrainian government has no control over a vast territory of the Donetsk and Lugansk regions. It is against this background that newly elected Ukrainian President Poroshenko announced on June 20 a unilateral ceasefire for humanitarian purposes, as well as stated that he has his own peace plan which basically boils down to offering an amnesty for those who lay down the weapons and did not commit serious crimes; providing a corridor via which volunteers from Russia can leave Ukraine; conducting an early local government election; and providing guarantees to use the Russian language in business practice (a bit later he made public a draft of a new Constitution of Ukraine which provides,

among other things, for governor elections). A few days later after this the leaders of the self-proclaimed republics announced a ceasefire, and slow negotiations were opened (during which mutual exchange of fire continued but less intensively) between them and representatives of the Ukrainian government, with the participation of representatives from Russia and the Organization for Security and Cooperation in Europe (OSCE). Yet there is no visible subject-matter to negotiate – the militants insist on independence of the self-proclaimed republics from Ukraine, which the latter cannot accept. President Putin stated on June 25 that he submitted a proposal to the Federal Council (Russia's upper house) to withdraw the approval for sending Russian troops to Ukraine, which the upper house gave to him on March 1, 2014. Russian TV channels have lowered substantially the degree of criticism and coverage of the Ukrainian government. At the same time, a new trend has emerged, explaining that sending Russian troops to eastern Ukraine is extremely disadvantageous, it is a trap which Russia is being lured into by its western enemies.

It is hard to disagree with Russia's official TV channels as far as a military incursion is concerned, when they talk about disadvantages Russia might face in case of incursion to eastern Ukraine. Indeed, it would result in even tougher sanctions against Russia. In fact, developed countries may try to physically replace any Russia's export to the extent to which a replacement may be found, as well as block Russia's access to capital markets. It doesn't mean that Russia would collapse instantly upon such measures, but they would be very painful for the country whose major revenues are generated in one way or another from foreign

trade, given that the Russian economy isn't in good shape as it is, whether sanctions are imposed or not. However, the Russian federal government has put itself in a unfortunate situation which it cannot escape from just like that. Blocking the border with Ukraine whereby the self-proclaimed republics will face a military defeat from Ukrainian government troops would cause a serious damage to Russia's image domestically. Keeping intact the situation under which weapons and military personnel are "leaking" through the border, allowing the self-proclaimed republics to preserve a status quo, has started to cause damage to Russia's image too – death toll, damage assessment, and refugees to Russia will keep growing. The topical question to be answered today: what is the point of the conflict for Russia?, what do the Russian authorities want to achieve?, what are people supposed to die for? "Controlled chaos" theories are very popular among military strategists, however none of them is likely to confess that controlled chaos is what Russia is seeking both on its own border and the territory where ethnically close people live. A breakup among the militants and readiness of a separated moderate group of them to sign political arrangements with Kiev might be most realistic option. Such an agreement could be a representation of rational tradeoff given the current situation.

Gas negotiations with Ukraine have reached no agreement. As a reminder, discrepancies between the parties boiled down to the following issues: redemption of the outstanding amount owned by Ukraine; whether there are discounts under the 2010 agreement on the Black Sea Fleet in the Crimea signed by V. Yanukovich (because Russia considers the Crimea a Russian territory while Ukraine doesn't); the need to enter into a new contract (this is what the Ukrainian party is seeking) or respective sub-agreements to the existing contract of 2009 which was signed by the government chaired by Y. Timoshenko. The parties managed to bring together their positions, but failed to reach an agreement – Ukraine redeemed a part of the outstanding amount at the end of the previous month, but refused to redeem the remainder until a full agreement is reached. Ukraine suggested \$326 for 1000 cubic meters of gas, Russia offered \$385 for 1000 cubic meters. Finally, on June 16, Russia announced transitioning to prepayment for gas, halting gas supplies to Ukraine while transiting via Ukraine the gas designated for Europe only. Furthermore, both parties filed lawsuits against each other to the Stockholm Court of Arbitration. They still have some time to be able to reach an agreement, because Ukraine accumulated 15 million cubic meters of gas in its gas underground storages, which should help Ukraine out until

approximately the upcoming new year. However, the parties will have to come to an agreement when these dates get closer: although both Russia and Ukraine are seeking to reduce as much as possible their dependence on the Ukrainian transit of Russian gas, almost half of the gas consumed in Ukraine is supplied from Russia, as well as half of the gas designated Europe is transited via Ukraine. Mathematically, the current difference in prices can be easily averaged to about \$350 for 1000 cubic meters of gas.

In June 2014, Russia continued its complicated negotiations with the European Union about The South Stream gas pipeline project. As a reminder, the European Commission considers that the project fails to meet the standards of the so-called "third energy package"¹ adopted in 2009 and effective since 2011, under which the gas seller must either hold no controlling interest in its transiter (Gazprom holds 50% in The South Stream gas pipeline project) or allow various legal schemes under which transiter's actions will have to be approved by supervisory bodies established by the European Union. Russia believes that The South Stream gas pipeline project, first, legally exists before the European Commission made the respective decisions (its operator was established in 2008), second, the third energy package as such contradicts various agreements concluded between Russia and the European Union, in which no deterioration of economic conditions of cooperation is stipulated. The final construction of the gas pipeline – via the Black Sea to Bulgaria and Serbia – ends in Austria (it was decided not to lay the pipeline further to Italy via Slovenia, because the demand for natural gas remains weak while the market is competitive in the South European Countries). Russia signed interstate agreements with all these countries, and construction has been commenced this year. However, Bulgaria announced its suspension in June 2014. Bulgaria, one of the poorest countries in the European Union, will receive more than 15bn euro of financial aid from Brussels in the period of 2014 to 2020. The said amount is much bigger than a profit worth a few billions of euro from The South Stream gas pipeline. There are more circumstances though: Russia is Bulgaria's major trade partner, and Bulgaria depends largely, even more than Ukraine does, on imported Russia's natural gas (85%). Austria and Serbia still declare planned construction. During his visit to Austria President Putin accused the United States of the problems faced by The South Stream gas pipeline project: "...They are making every effort so that the contract is not signed, for the purpose of supplying their own liquefied natural gas". Indeed, the gas pipeline isn't quite

1 The conventional name of a big package of energy directives issued by the European Commission.

feasible economically, aside from substantial construction costs (at least 15bn euro) via the deep Black Sea and its transit costs which are well-known to be higher than transit costs via Ukraine, but the rationale is to create an opportunity to substantially replace gas transit via Ukraine (The South Stream gas pipeline project is expected to have a capacity of 68 million cubic meters, whereas the capacity of Ukrainian transit in 2013 was 86 billion cubic meters) whereby the Russian authorities will have the freedom of politico-economical maneuvering. On the contrary, neither the United States, nor many European countries would like to see Russia enjoy such a freedom.

Late in June, Finance Minister Anton Siluanov and Minister of Economic Development Alexei Ulyukayev happened to have a bitter dispute on what should be done with the 2014 pension accruals. As a reminder, no new contributions have been made to the funded pension scheme since H2 2013 upon the pretext of “going public”, “providing guarantees”, etc., undertaking reforms in pension funds. However, experts noted at that time that the government’s policies resembled a “creeping nationalization” of the money. In his interview to *Vedomosti* newspaper Mr. Ulyukayev stated that he would suggest that the Russian Government should return the pension accruals to their owners. Mr. Siluanov stated expressly that the money had been confiscated to support the Crimea and the city of Sevastopol: *“.....There are no sources for this, there is no way the money can be returned, because it has been spent on the Crimea, counter recession measures. This resource still exists and is most likely to be spent to support the socio-economic development program in the Crimea and the city of Sevastopol. Saying so easily that we will return the money is an ill-estimated proposal which wasn’t discussed. The author should be asked at the cost of what it can be done”*. The Russian government authorities have an overwhelming temptation to confiscate the money from the funded pension component – it is much easier than cut off budget expenditures, besides, there are also hopes that individuals won’t resent it, because the pension accruals are “virtual”, they cannot be put in a pocket instantly. However, such hopes have no solid grounds – the intensity of transfers of pension accruals from Vnesheconombank (VEB) (6 million applications for money transfer from VEB were submitted at 2013 year-end alone, and a total of 25 million persons have transferred their money from VEB to date) is indicative of individuals being aware of the problem. It is also important that many entities among owners of non-government pension funds (NGPF) are related to powerful state-run companies (such as OJSC Russian Railways, Sberbank, VTB) and major businessmen (for example, Gazfund is

affiliated with Y. Kovalchuk), and they don’t yearn for the money to be spent in favor of the Crimea or the state budget as such – in this context, public monopolies and oligarchs are paradoxically acting as allies of ordinary citizens. One may hope that the pension accruals will stay intact, otherwise it cannot radically resolve the budget-related problems faced by this country (they amounted to a bit more than Rb 1 trillion at 2013 year-end), rather it will seriously discourage legal labor and encourage “backdoor” incomes and tax evasion and reduce social security contributions.

In June 2014, Prime Minister Dmitry Medvedev signed an executive order which changed the procedure for the management of assets of the National Wealth Fund (NWF). For now 40% of NWF’s resources can be invested in any infrastructural projects or deposits in VEB which in its turn provides funding of infrastructural, and not always justified, costs, as is the case with the venues and facilities constructed for the Olympic Games in Sochi, projects, another 10% in projects in which the Russian Direct Investment Fund (RDIF) is participating, another 10% in Rosatom (The State Atomic Energy Corporation) projects, therefore making up 60% or less. At a first glance, non-conservative instruments in investment have increased substantially (from 40 to 60%), however, this has been an “on-paper” increase so far. For example, the RDIF is unlikely to choose its limit simply by virtue of its own rules which require foreign co-funding. The rest of the costs will be approved on a case-by-case basis, same as before. In general, however, another formal obstacle to large-scale spending of the NWF resources will be removed. These resources were equitably meant to be a stabilization instrument for the pension system, not a development institution. It was already announced about the allocation of resources to extend The Baikal-Amur Mainline (BAM Railway) and Trans-Siberian Railway, construct the Central Ring Motor Road. Under discussion is allocation of resources for the construction of nuclear power stations in Turkey and Finland, expansion of the capacities of the Moscow air hub, the Moscow-Kazan High-Speed Railway, construction of a gas pipeline to China, etc. The common problem remains the same: all the projects formally declare payback, although it is not just unobvious, but rather unlikely to happen for many of them, as is the case with the Moscow-Kazan High-Speed Railway which have no new passenger traffic, not to mention a new cargo traffic. A similar situation is being faced by the BAM Railway which currently, prior to any expansion, isn’t operating at full capacity, and goes via desert areas where a hypothetical emergence of industrial clusters is still hypothetical, as it used to be in the Soviet era. It would be reasonable to focus on projects which replace ca-

capacities that are visibly falling short (a good example of this is the Moscow air hub whose capacities are seriously falling short, and profit from its expansion can be more or less visible), but it actually is referred to a non-transparent struggle between lobbyists, the economy of the projects remains unpublished and undiscussed.

In June 2014, the fact that The Investigating Committee of the Russian Federation was empowered to initiate at its own discretion criminal cases on tax evasion, without having to obtain approval of the Federal Tax Service of Russia (FTS of Russia), had an adverse effect on the business community. The former procedure which was introduced in 2011, relieved drastically the pressure from businesses – the number of criminal cases was reduced by six times (!), however, representatives of security and law enforcement agencies were not happy at all. In 2013, President Putin supported the initiative of A. Bastrykin, Head of The Investigating Committee of the Russian Federation, on empowering investigation officers to initiate criminal cases at their own discretion. A respective draft law was adopted in the first reading, but a hope remained that it might be changed in the second reading. However, no improvement was achieved as a result of consultations between the Investigating Committee and the FTS of Russia. For now investigation officers in the

FTS of Russia will request a “certificate” and then they can do what they want to do, no matter what is written in the certificate, even though no criminal offence has been committed according to the FTS of Russia. However, they say that damage, if established, must be assessed using the method of the FTS of Russia, thereby making it less possible for an arbitrary interpretation to happen.

Deputy Minister of Industry and Trade of Russia A. Rakhmanov was appointed CEO of the United Shipbuilding (USBC), the fourth CEO over the last few years; former CEO V. Shmakov – from UralVagonZavod – held the office as little as one year and fell afoul of the core department. Running short of either public or international contracts, the shipbuilding industry has found itself in a vicious circle – financial problems are interfering with the performance of the existing contracts, while failure to honor some contracts has resulted in losing a few customers that have left – as was the case with India, after a years-long delay in the performance of an aircraft carrier contract. As far as it can be understood, Shmakov had an objective to reorient the shipbuilding industry to meet the needs of the Fuel and Energy Complex, in particular the production and transportation of offshore hydrocarbons. The objective still remains to be fulfilled though. ●