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Prospects for Putin 4.0

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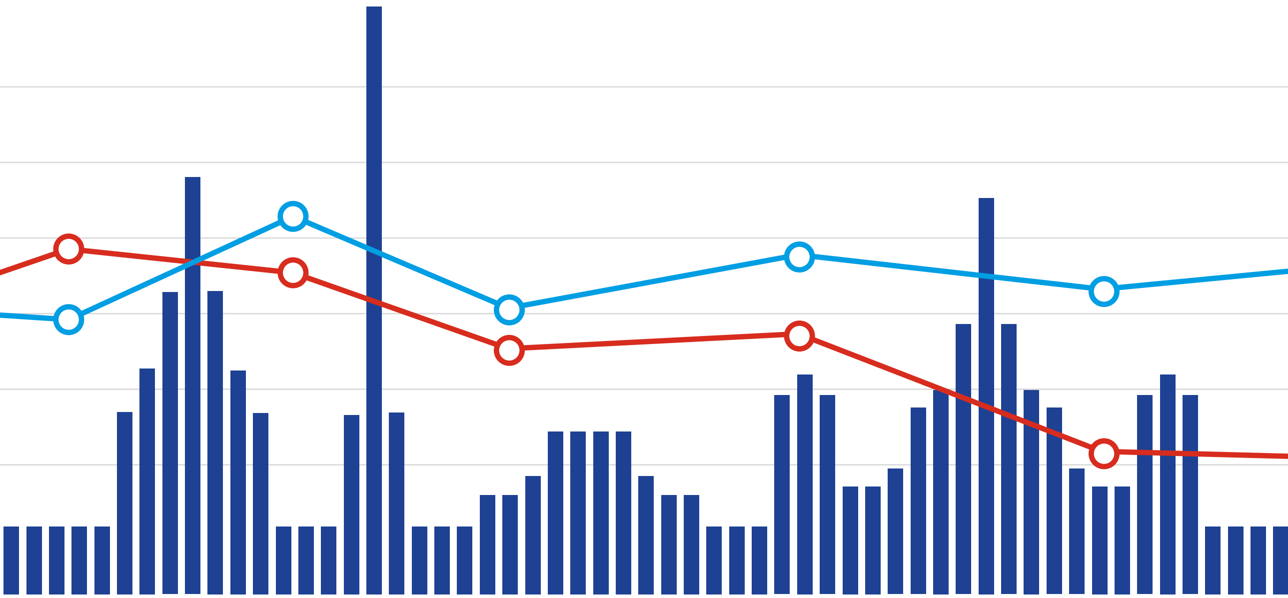

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Editors: Andis Kudors, Jānis Hermanis
Assistant to the Editor: Anna Lasmane

Authors of articles: Mārcis Balodis, Maria Domanska, Aleksandr Golts, Mārtiņš Kaprāns, Kai-Olaf Lang, Marius Laurinavičius, Vladimir Milov, Dmitry Oreshkin, Vita Spivak, Kirsten Westphal

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Layout: Andra Liepiņa
Cover design: Agris Dzilna

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Foreword

Russia's international role and its developmental trends have always been the subject of widespread debate, as it is a country with a particular mentality. In May 2018 Vladimir Putin has assumed the office of the President of Russia for the 4th time. As he begins his term, the president has also defined a number of rather ambitious economic and social goals that Russia should achieve over the next six years. However, Putin has held power long enough so his potential could be judged not only by his promises, but also by the results of his political activities so far. Putin has previously said that the collapse of the Soviet Union is the biggest geopolitical disaster of the last century. This quote says a lot about today's true goals, ambitions and foreign policy priorities of Russia. Such expressions are more of a yearning for the past than a desire to change for the sake of development.

The USSR was once one of the two most influential world powers. By contrast, Russia, the legal heir of the Soviet Union, has today lost much of its former influence, including in the economic sphere. Russia's share of the global economy is currently only 3.1 percent. The Russian economy ranks sixth in the world (in terms of GDP PPP; eleventh in terms of nominal GDP) with China, the United States, India, Japan and Germany ahead of it. Russia's presidential decree of May 2018 stipulates that the country should reach the top five of the world's largest economies by 2024.

Since the collapse of the USSR, Russia has undergone significant changes. In the 1990s, when Yeltsin was president, country's economy shrank almost every year. According to the International Monetary Fund, Russia's share of the global economy fell from 5.2 percent to 3.1 percent between 1992 and 1999. Against this background, it was easy to denigrate the economic, political and social transformation of Russia under Yeltsin's presidency as a submission to the conspiratorial interests of the West. The effect of 'shock therapy' in Russia – a country without democratic traditions – has certainly proved more harmful than, for example, in Western Europe.

When Putin became president, Russia experienced rapid economic growth (on average 7 percent per annum) for almost 10 years, largely due to the significant rise in oil prices. This relatively successful period has not only secured an increase in Russia's share of the global economy (from 3.1 percent to 3.9 percent), but also boosted president Putin's popularity. In 2007, Time named Putin Person of the Year. However, further development was no longer so convincing. As a result of the global financial crisis, Russia's economy fell by 7.8 percent in 2009, followed by a more moderate growth period than at the beginning of the century. Following the military conflict in Ukraine, sanctions by the EU and the United States were imposed on Russia and the following drop in oil prices led to a further decline in its economy in 2015. Russia experienced a sharp fall of its currency exchange rate, consumer price inflation and the depletion of the government reserve fund accumulated during 'the good times'.

Lately, Russia has been able to return to weak economic growth due to global economic development and higher level of oil prices. The FIFA World Cup also provided a temporary boost to the economy in 2018. Meanwhile, Russia's share of the global economy has fallen to 3.1 percent in 2019, the same level as before Putin took office. In addition, the IMF forecasts that this share will fall to 2.8 percent in 2024, meaning that Russia's position in the global economy will deteriorate as a result of Putin's rule.

Russia undoubtedly has great potential for development. It has an extensive natural resource base, and virtually every element of the Mendeleev table is available in the country. Russia is estimated to hold about 30 percent of the world's natural resources. According to the World Bank's estimates, Russia's total natural resources value reaches $ 75 trillion, 3 times the annual gross domestic product of the United States.

The experience of countries around the world shows that the economy is undergoing gradual structural change over time, and that the level of development of the countries is linked to their economic model. Lower income countries have a high share of the primary sector, which includes the extraction of natural resources and raw materials. Middle-income countries have an increased share of the secondary sector (including the production of goods using materials supplied by the primary sector), while the tertiary sector (comprising a variety of services) dominates the advanced economies. The technological level of the countries concerned, the quality of the educational system, investment in research and development, etc., are essential for moving towards a higher level of development.

Russia can be considered as a country with a high share of the primary sector. Both Russia's economy and its budget are highly dependent on commodity prices (especially oil and gas) in the global markets. The mining industry's share of the Russian economy in 2018 was 13 percent. The share of natural resources and raw materials in 2018 was more than 60 percent of all Russian export revenues. These conditions are beneficial in times of global economic growth and increasing demand for raw materials. However, such an economic model is also associated with increased vulnerability and impedes its long-term development. Increased returns from the primary sector dampen business interest in other 'tradable sectors', in particular industrial production, leading to increased imports and limited domestic export potential. It also contributes to the concentration of resources in the hands of a narrow elite group, income inequality and corruption. This is called 'a resource curse'. Some resource-producing countries (such as Canada and Norway) have managed to avoid this curse with well-targeted policies. The negative spill-over effects of the energy sector can be mitigated by promoting transparency in public administration and utilizing resource export revenues for public investment, development of other sectors and economic diversification.

Russia would need to change its economic model and ensure a technological breakthrough. Such a desire has been seen in Russia before, with President Putin repeatedly talking about the country's far-reaching plans. What hinders their implementation? Here comes the sacramental question of American commentator David Remnick: "Can Russia Change?" (Foreign Affairs, 1997, No. 1). In the 1990s, this country at least tried to break the umbilical cord with its past of dictatorship and imperialism, while in recent decades we have seen more nostalgia for worship of the 'great past', its symbols and values. Unfortunately, this is also reflected in Russia's international behaviour, where, according to Lithuanian foreign minister Linas Linkevičius, it is no longer 'a superpower but a super-problem'. Russia is a country with its own specific ambitions, seeking to translate international norms and treaties in a way which is only good for itself – a similar policy is currently being pursued by US President Donald Trump.

Putin's ability to deliver an economic breakthrough is questioned by a number of indicators of development potential, where Russia lags far behind other leading nations. Russia currently ranks 46th in the Global Innovation Index. According to the World Bank, its R&D expenditure (1.1 percent of GDP) is twice as low as the OECD average (2.4 percent). Expenditure on education (2.6 percent of GDP) is also below the OECD average (4.4 percent). Meanwhile, Russia spends relatively much on military spending (3.9 percent of GDP), and is one of the few countries in the world to spend more on defense than education. Russian messianic aspirations, particularly manifested in the post-Soviet space, and its desire to engage in military conflicts outside the country, places an additional financial burden and deprives it of resources to deal with domestic issues. Disproportionate consumption of resources is also evident in other areas, such as Russia's most expensive winter Olympic Games in Sochi in 2014, which cost € 50 billion, equivalent to one quarter of Russia's annual budget. This shows that Russia is focusing more on creating an impressive external image than on fundamental changes to improve the welfare of its citizens.

It would be important for Russia to create favourable conditions for foreign investment, but the opposite has happened in recent years – after the annexation of Crimea and Western sanctions, foreign investment has declined. Potential investors are also deterred by the very high level of corruption – according to Transparency International Corruption Perception Index, Russia ranks 138th (among 180 countries, on a par with Iran and Lebanon).

Putin has now been under Russian leadership for longer than the former leader of the USSR Brezhnev, associated by many with a prolonged period of stagnation. How will Putin 4.0 differ from all previous ones? Is Russia capable of a rapid economic breakthrough in order to increase its global role and improve the quality of life of its people? Are the national development goals set by President Putin realistic or is it just an illusion? What are the major obstacles and challenges that need to be overcome in order to deliver quality change and achieve the goals set? the answers to these questions will be explained further in this book.

Rīga, January, 2020
Jānis Hermanis

Introduction

Vladimir Putin, addressing the Federal Assembly, government, regional authorities, courts, public figures and media on 15 January 2020, said at the beginning of his speech that “there is a clear demand for change in our society today.” Demographics, education, health were topics that Putin paid particular attention this time. The President concluded his speech with: “Russia is facing historic breakthrough challenges (*proryvnye istoricheskie zadachi*), and addressing them is an important contribution for everyone. Together, we will definitely make a difference in our lives for the better.” For the Russian elite, life is already quite well off in material terms. Were constitutional changes really intended for the sake of the common people in Russia, or was it to preserve Putin’s system of power?

Putin began building his power system during the first term of the presidency by taking control over major financial flows from the sale of energy resources among other things. This was done by sending his trusted persons Alexei Miller and Dmitry Medvedev to Gazprom. Igor Sechin had and still has to run Rosneft. The second important step in the establishment of the power system was to take control over major television channels, as in the early 21st century the most effective way to the minds and hearts of the broad Russian population was through the TV screens. Propaganda has helped to maintain power, but it does nothing to help create a sustainable economic model for the country. The words ‘technological breakthrough’ were also often heard when Putin became head of state for the fourth time in 2018. Listening to Putin’s speeches of recent years, one feels as if he has not been in power for twenty years and is not responsible for the missed huge opportunities for modernization of Russia brought about by high oil prices. Instead, Putin’s power vertical has provided centralized power and a fabulous income for some of Putin’s trusted billionaires, not for a large society.

Dmitry Medvedev, when becoming President of Russia in 2008, set out an ambitious plan for his presidency to fight corruption. It has already been realized after one year that such ambitions should not be set, as a serious fight against corruption would require dismantling, or at least severe shaking of the entire Russian system of power and prosecuting elite figures close to Vladimir Putin. The next goal, defined by Medvedev in 2009, was the modernization of Russia. Unfortunately, it was limited to the economic dimension, not the political one. And even in such a limited way, it was not implemented. The creation of the Skolkovo Innovation Center is not enough, even if it works well; the peculiarities of the development of Russia's regions do not allow introduction of new practices. If the current situation is quite acceptable for Putin's elite as providing for them not only power but also wealth, the real victims are the Russian people, whose social benefits and prosperity are like a distant mirage. In a number of life quality indicators Russia, a country rich in energy, metals and minerals, lags far behind Western Europe and the United States – countries that Kremlin's propagandists are relentlessly disparaging and mocking.

Medvedev's updated economic modernization was, in part, a facade name of Russia's attempt to plug holes in the state budget with a framework of "cooperation with the EU to modernize Russia". A real economic transformation would require political changes to ensure the independence of the judiciary and the liberalization of the internal energy sector, which would increase competition and foster the development of an entrepreneurial culture. The Kremlin was afraid that Mikhail Khodorkovsky and similar businessmen would compete with the center for power in the process of liberalization, so no regional activity on their own was allowed. Labor productivity is boosted by internal competition in capitalism, but it has been in part replaced by efforts of businessmen to find favor with the president, governors and other local authorities of modern Russia. The system in which Putin's friends receive special favors, such as the diversion of taxpayers' money to counter the effects of Western sanctions, is not conducive to the functioning of the free market. Russia could attract more investment (including innovative projects) if foreign investors were not afraid of raiderism (deprivation of business through legal, semi-legal and illegal methods) and 'telephone laws' (influencing court decisions by telephone calls from high-level government officials). Without fundamental political reforms, such an objective cannot be achieved.

The history of Russia shows the campaigns of modernization and industrialization that have been carried out from the top down, as is already accepted in totalitarianism and authoritarianism. Peter the First made a rapid change, with men having to shave their beards and start following European fashion in clothing. Innovations were introduced through ruling with an iron rod – it was dangerous to say 'no' to the emperor. Neither Stalin's industrialization took into account anything, including human lives. Will Putin implement such modernization? Even if he wanted to, he could not do it, because much of today's Russia's population is not like under Peter the First, and therefore they would not submit. Will the 21st century Russia's leader follow Western modernization scenario? Rather not, as political change would make him and his circle of confidence lose power. So, the forecast is simple – there will be no real political and economic modernization of Russia while the Putin system persists.

People in Putin's circle of confidence regard political reforms against the backdrop of the consequences changes introduced by Mikhail Gorbachev – the collapse of the Soviet Union. Gorbachev tried to ventilate the barn, but it collapsed. Belarusian President Alexander Lukashenka once said that the "power, as grandfather Lenin taught, must be held firm." the Kremlin has analyzed the course of the Russian Revolution and the modern social revolutions. Indeed, the last acting USSR leader Gennady Yanayev had trembling hands during the press conference after the coup of August 1991. Whether the fact that hands of today's Russian leader do not tremble will help to avoid shocks, just the time will tell.

This book has been produced by an international team of researchers. In the first article of the collection, Maria Domanska, a Polish researcher, examines Russia's political model, Vladimir Putin's system of power, which also determines how the country's economy works. Domanska examines how legal nihilism prevails in Russia and the disregard for private property rights affects opportunities to modernize the economy and attract foreign investment. Vladimir Milov, a Russian politician and energy expert, will look into the accelerating changes in global energy demand. He puts a question: Is Russian power ready to seriously develop other sources of income and diversify its economy? High oil prices have allowed Vladimir Putin to maintain the minimum income he needs during his reign, thus preventing revolution in the country, and allowing to postpone necessary reforms. Political inactivity of citizens and massive propaganda by the authorities have ensured that the power elite has the *status quo* unchanged.

German experts Kai-Olaf Lang and Kirsten Westphal review in their article the Russia-EU relations in the field of energy supply. Researchers delve into both the history of these relations and the impact of the annexation of Crimea on EU-Russia relations. The article also examines how energy trade will eventually be affected by the EU's commitment to green energy. Alexander Goltz, a military expert, examines the dynamics of Russian military spending in his article. Defense spending has been a very important item in Russia's federal budget for several years. Goltz analyzes how the lack of transparency has affected corruption and ineffective use of public funds.

Russian regional policy and development expert Dmitry Oreshkin discusses Kremlin policy towards Russian regions in his article. During Vladimir Putin's reign, regional policy has facilitated the flow of resources to the center, preventing the regions from effectively managing themselves. Oreshkin examines how centralized economic policies have led to dramatic differences in living standards between Russia's regions, Moscow and St. Petersburg. From the point of view of the existing Russian authorities, such a model is convenient because poor regions are easily manipulated and retain their political loyalty, but in the long run it poses risks to the integrity of the country. China expert Vita Spivak writes in this book on Russian-Chinese economic relations. She examines how Russia is showing a positive attitude towards China by giving it access to strategic areas, including military technology and the energy sector. However, small and medium-size Chinese investors face the suspicion and inaction of Russian local officials.

Mārcis Balodis, a researcher at the Centre for East European Policy Studies, looks at Russia's dominant position in the Eurasian Economic Union (EEU), where other member states are unable to balance regional hegemony. Following the illegal annexation of Crimea in 2014, even Russia's closest allies to the CIS integration projects – Kazakhstan and Belarus – felt some discomfort that did not facilitate real and credible integration into the EEU. Moscow's pressure on Belarus is growing as the Kremlin no longer wants (and is unable) to subsidize Alexander Lukashenka's regime. Russia buys Belarusian loyalty with reduced oil and natural gas prices, but with each price dispute the atmosphere becomes more heated.

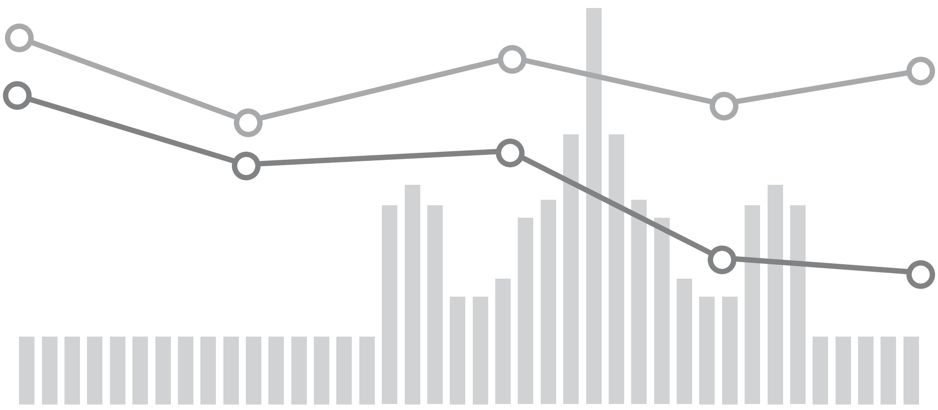
A Lithuanian expert on Russian cleptocracy and hybrid warfare instruments, Marius Laurinavičius focuses on the destructive impact of money flowing from Russia to the West. Laurinavičius draws readers' attention to the fact that political parties, churches, universities, football clubs and charity projects in several countries are being funded from Russia to increase Moscow's influence. Mārtiņš Kaprāns, a media expert and communications scientist, analyzes how economically-saturated narratives are used by official Russian-organized propagandists to influence audiences in the Baltic States. Propaganda and misinformation initiated by the Russian authorities reach the Baltics through extensive Kremlin-controlled media. Propagandists purposefully avoid looking at facts that show that the Baltic economies are growing faster than many other European countries for years, not to mention the CIS countries.

There are many more economic issues we wanted to explore, but the scope of the project sets its limits. The book is a compilation of two approaches; research methods of both political science and economics help to understand current events and trends in Russia. Will Russia succeed in modernizing its economy during Vladimir Putin's fourth presidency? Is Russia prepared for the eventual change in the EU's demand for energy as a result of the EU turn to greener consumption? Does Putin's power system promote innovation and balanced regional development? Answers to these and other questions have been sought by article authors from Russia, Poland, Germany, Lithuania and Latvia.

I would like to thank the project partners Peer Krumrey, Director of the Friedrich Ebert Foundation (FES) in the Baltic States, Krists Šukevičs, FES Project Manager, Andris Kužnieks, Acting Head of the Representation of the European Commission in Latvia, and all the scholars – authors of the articles.

Riga, January, 2020
Andis Kudors

Part I: Domestic Development



State of Russian Economy and its Influence on Putin's Politics at the 4th Term

Maria Domanska

Vladimir Putin's third presidential term (2012–2018) brought about numerous negative changes in Russian political, economic and social reality. After mass protests in 2011–2012 that accompanied Putin's return to presidency after a four-year absence, the Kremlin decided to crack down on human rights and civil society organizations. War against Ukraine and ensuing Western sanctions weakened Russia's position in the international arena, while financial-economic crisis of 2014–2016 and subsequent stagnation together with a poor quality of state governance had their repercussions on the domestic scene. The first two years of Putin's fourth term in office (the final consecutive term he is permitted under the current constitution) have witnessed growing frustration among the society, serious fluctuations of public support for the authorities, and an increase in the number of local protests of mainly socio-economic background. As the prospects of economic development remain disappointing, the Kremlin may face some, albeit not dramatic, challenges in the run up to the next presidential election in 2024.

Political foundations of Russian economic model

Factors that determine the shape and logic of Russian economic model are predominantly of political character and stem from the very nature of Russian authoritarian regime. The political-economic system is inefficient in terms of development, but relatively effective in terms of control. State interests are identified with personal and group interests of the ruling elite. Real mechanisms of decision-making and ruling the country, which are informal in nature, are based on personal or group ties in politics and business. State-business relations are subordinated not so much to rational economic calculations as to the key interest of the political elite which is to maintain and reproduce the current system in a long run.

This system can be described as[1]:

- neo-patrimonial, due to specific understanding of the state and its resources by the ruling elite as a de facto property of a narrow group of decision-makers, in which the central role is played by the President. By this logic, the boundaries between the private and the public are systemically blurred. Political power is converted into access to lucrative assets and corrupt revenues. Profiting from specific areas of economic activity depends on the arbitrary decisions of the leader and his entourage, and mostly constitutes payment for one's loyalty or service.
- patronal, due to the predominance of informal networks within it. Formal institutions and written law often serve as smokescreens concealing the real mechanisms of power where informal rules are of primary importance.The true extent of the state institutions' competence, as well as social status and the scope of the rights, duties and privileges assigned to the representatives of the elite and ordinary citizens, are determined not as much by universal – institutional and legal – relationships, as by personal or business bonds based on loyalty and protection. It leads to widespread clientelism as an organizing principle of social-political relations across the state, and to the dominance of 'manual mode' of state governance.
- kleptocratic, due to being consumed by systemic corruption resulting in significant losses to the state budget[2] and in the general population's continued low standard of living. It is manifested in its most colourful forms in the direct and large-scale embezzlement of state property by selected members of the elite.
- 'Chekist', due to the concentration of the decision-making powers in the hands of politicians with roots in the special services (led by the President, a former KGB officer), with their particular mentality and methods which have been transferred to the basis of state policies. The core value in this system is an absolute primacy of control and supervision over economic development, which assumes the use of political repressions as a standard mechanism of state governance.

All factors mentioned above impede economic growth. Politics and economy are intertwined in a feedback loop where political clout makes it possible to gain economic assets which in turn help solidify political power. It leads to a mafia-like model of state governance (sometimes overlapping with organized crime), where widespread pathologies are not only tolerated but constitute an inherent part of the system. Such a model can work only at the cost of the general public.

This logic results in bad investment climate as investors' money are never safe: legal protection of property rights is often purely illusory and investing in Russia is burdened with a significant risk of hostile takeovers. As a consequence, the Russian business and political elite members are strongly attached to natural resource rent as a relatively easy and quick way to enrichment. Needless to say, huge amount of money flows out of Russia every year and is most likely transferred to tax havens – according to some surveys, over one trillion dollars may have been siphoned off from Russia between 1994 and 2018[3]. This is done not only in order to evade taxes but also out of a desire to protect assets from Russian jurisdiction.

The scale of such operations makes one to raise a question about the actual role and effectiveness of Russian state institutions. Characteristic feature of Vladimir Putin's rule since early 2000s was a constant increase of the state control over economy, as well as excessive bureaucracy and the tightening grip on the public sphere. The estimated share the state had in the economy was 35% in 2005 and 70% in 2015[4]. The strengthening of redistribution functions of the state and the excessive development of the bureaucratic apparatus have weakened control of the way public funds are spent and made citizens and business circles dependent on budget funds (above all through social transfers and non-transparent public procurements). The situation of private business entities worsened after 2014 when, due to Western sanctions and economic crisis, a hard battle for dwindling resources began. Currently the state-owned enterprises keep expanding at the cost of the private business companies, including through informal 'nationalization' of the latter[5].

However paradoxical it may seem, this overgrown state is largely privatized. One of its main functions is to conceal and legitimize traditional patrimonial practices. The 'state' – understood as a system of public institutions which are depersonalized and autonomous vis a vis people holding political power – is constantly and intentionally being weakened, while the phenomenon of 'crony capitalism' keeps flourishing. The top managers of big state companies – like Igor Sechin, the CEO of Rosneft, or Viktor Chemezov, the CEO of Rostec, are de facto tenants and beneficiaries of rich 'fiefdoms' made up of state funds and assets. Huge amounts of state budget money are most likely transferred to their private accounts (usually through a complex system of multi-layered, opaque public procurement schemes). The same refers to Kremlin-supported private oligarchs parasitizing on lucrative state contracts (most salient examples are Putin's cronies: Rotenberg brothers, Gennadi Timchenko and Yuri Kovalchuk) and high-ranking officials entangled in political corruption[6]. As the so-called 'Panama Papers' published in 2016 revealed, not only the illegal off-shore schemes of stealing national property revolve round Putin's inner circle but most probably one of their beneficiaries is Russian President himself, although no concrete evidence has been presented against him.

While some big state and private businesses negotiate their privileges through obscure bargains with the 'collective Kremlin', the situation of the rest of companies in Russia – either big, medium or small – is much more vulnerable. Learning the lessons from two Ukrainian 'colour revolutions', where some businessmen directly supported anti-governmental protests, Russian authorities are determined not to allow free business to emerge. Despite the rhetoric of high-ranking officials, suggesting that the state is taking care of businesspeople's interests, there is no will to devise a systemic solution to their most urgent problems. They include systemic violations of the property rights, abuse of criminal law provisions in investigations into economic crimes, arbitrary actions by control and prosecution bodies, as well as the partiality of courts which frequently manipulate the course of the proceedings, as a consequence of which businesspeople increasingly often lose cases brought against them by the authorities. The proportion of acquittals in cases involving economic crimes remains below 1%. According to government estimates, the operation of the supervision system leads to business losses that reach 5% of GDP annually. Over 70% of entrepreneurs claimed in 2016 that the level of risk associated with doing business had risen since President Vladimir Putin started his third term in office in 2012[7]. Under such conditions Russia stands virtually no chance of succeeding in the global technological competition: bottom-up development of advanced technologies that could contribute to economic growth is often suppressed by politically-motivated repressions aiming to take control over every single sphere of social-business activity.

Current macroeconomic indicators and Russia's developmental prospects

After a two-year financial-economic crisis that hit Russia in 2014–2016, the country has been struggling with stagnation that – according to most assessments – will last for long. Average annual GDP growth in 2014–2018 oscillated around 0.5%[8], while the official forecast for 2019 is at 1.3% and for 2020 – at 1.7%[9]. According to the 2016 outlook by Russian Ministry of Economic Development, average annual growth up to 2035 will not exceed 2%. More recent document, published in 2018, presents more optimistic scenario (annual growth of 2.7% in 2020–2024 and 3.0–3.2% in 2025–2036)[10]. However, the lack of viable domestic sources of growth under the current economic model makes the previous forecast much more realistic. The prospects for Russia may be even worse, including the risk of GDP decline, if pessimistic forecasts of 2020 global recession come true[11].

The objective assessment of Russia's actual economic situation and its prospects is becoming increasingly difficult. Due to probable political pressure from the Kremlin the Russian Federal State Statistics Service (Rosstat) seems to practice a *sui generis* 'creative accounting' with regard the compiling and interpreting statistical data. Its aim is to show the society that socio-economic situation is stable. More credible data are usually offered by the Ministry of Finance, the Ministry of Economy and the Central Bank – within their spheres of competence.

Russian creative statistics

According to Rosstat's updated figures as of February 2019, in 2015 Russian GDP fell by 2.3% and in 2016 it grew by 0.3%. These figures differ significantly from those published initially (–3.7% and –0.6% respectively) and even from subsequent updates made afterwards. The GDP growth indicator for 2017 was also slightly revised from initial 1.5% to 1.6%. Official 2018 GDP growth rate of 2.3% is highly controversial as it was earlier assessed at 1.8% by the Ministry of Economy on the basis of preliminary Rosstat's data. The reasons of such sudden improvement of figures remain unclear as Rosstat was not able to present compelling justification for surprisingly good production rates in selected industrial sectors.

While some hindsight revisions of statistical data can be attributed to certain objective factors, including changes in methodology, in this case the scale of the change, the unprofessional manner of presenting the data, and their selective inclusion in the Rosstat reports undermine the credibility of the presented figures and their explanatory value[12].

One of the most salient features of Russian economy remains its dependence on energy exports as the main source of budget incomes. While the Ministry of Finance declared in December 2017 that the share of energy revenues in the federal budget should decrease to 33% by 2020, so far it has actually oscillated at a much higher rate (39.6% in 2017 and 46.3% in 2018, in comparison to 18% in 1999). Raw materials, mainly oil and gas, also prevail in Russian exports: in 2018 their share reached almost 64% (in comparison to 45% in 1999)[13]. Revenues from raw materials let Russian government gather financial resources to cushion the effects of unfavourable economic trends. Due to measures taken in recent years (including cautious budgetary spending based on relatively low predicted oil prices), in 2018 – for the first time in seven years – the state budget was executed with surplus of 2,7% of GDP[14]. Taking into account that the Central Bank and National Wealth Fund have also increased their financial reserves[15], currently there are no major risks for the budget sustainability in the short-term perspective[16]. Most forecasts of expected average oil prices in the coming years remain within a range of US $ 50–70/bbl, while the budget for 2020–22 is based on conservative estimates of the average price of crude oil well below US $ 50/bbl[17].

Energy exports contributed to a large extent to Russian uninterrupted prosperity in the period of 2000–2007 due to steadily growing oil prices. Constant injections of 'easy money' from the raw material rent to the real sector and social transfers allowed the Russian elite to avoid systemic reforms and, regardless of this, to maintain high production and employment levels. As a result, all social groups benefited from the oil prosperity, though to a different extent. However, the over-significance of energy sector in Russian economy led to serious underdevelopment of other sources of economic growth and gradually Russian economic model began to malfunction. In 2012–2013 (after a short recovery from the 2008–2009 economic crisis), when oil prices stopped rising, although still remaining high, the GDP growth started to slow down[18]. Dependence on raw materials not only hinders Russian prospects of innovative development but also makes the country highly vulnerable to external factors which the Russian authorities have limited influence on: fluctuations of prices and trends on export markets which do not favour Russia (including the strategically important European market)[19].

One of indicators of Russia's low growth potential is the dynamics of capital flows and foreign direct investment. Over the past 18 years (except for 2006–07) Russia has seen a net outflow of capital. Foreign investments entering Russia in that period, meanwhile, have been focused in the energy sector, confirming the Russian economy's dependence on it[20]. FDI into Russia accounted for only 0.2 percent of GDP from 2015–2018, putting it at the bottom of the list of emerging markets[21]. In 2018 there was a record foreign capital outflow of net 6.5 bln USD from Russian companies (the highest level since 1997) and this trend continued in 2019[22]. According to the enterprises, main internal constraints of industrial growth are insufficient demand and a lack of clarity in the current economic situation and its prospects[23]. Foreign investors keep indicating to 'unpredictability, administrative barriers and political processes' as the main reasons for the decline in foreign investment in Russia[24]. Taking into account bad investment climate the only viable way to galvanize economic growth seems to be the pumping of state financial reserves into the real sector of economy. In 2018 the investment growth was generated mainly by the completion of the Crimea bridge construction and 2018 World Cup sport infrastructure and once these flagships of public investments were completed the investment level in the first half of 2019 significantly decreased[25].

While Western economic sanctions did have impact on Russian financial and economic situation, especially in 2014–2015, Russia was able to adapt to the sanctions regime gradually. The overall impact of sanctions so far imposed on Russia on its GDP growth remains moderate (around 0.5% of GDP)[26], and they do not constitute an imminent threat for Russian economic-financial stability.

However, the sanctions – especially those imposed by the US – will undermine the long-term prospects of Russian innovative growth due to the restrictions on trade and investment cooperation and an export ban for certain goods and technologies, including in the energy sphere.

With hindsight it becomes clear that the main victim of economic stagnation has been neither the state budget nor even the real sector of the economy[27]. It has been above all the Russian society – especially its poorest strata. Proof of this can be found in the dynamics of real disposable income of the population: in 2019 they keep falling for the sixth year in a row. There is also a significant number of people whose income is lower than the minimum subsistence level (12.7% or 18.6 million people in the second quarter of 2019)[28]. Official data regarding inflation and unemployment (both below 5%) speak very little about the market reality. The share of households' spending on basic material needs, like food and clothes, keeps growing. At the same time there is a growth in the population's indebtedness that reached the maximum level since 2013, while 60% of those indebted find it difficult to meet their financial obligations[29]. Growing number of those surveyed claim they take loans in order to satisfy their basic material needs.

In an attempt to conceive a flywheel to revive Russian economy, in May 2018 Vladimir Putin announced a new developmental strategy for the period up to 2024, based on thirteen 'national projects' co-financed by the state budget. It focuses on the modernization of economy, infrastructure investments, creating a business-friendly climate, and improvement of the quality of public services. However, taking into account the systemic political barriers for economic development, widespread maladministration and misuse of public funds, and the unwillingness of private companies to participate in 'the national projects', one can assume that they will prove to become another 'Potemkin village' rather than an opportunity to take a leap into a brighter future. According to some assessments, the real impact of this newly-announced strategy on economic growth will reach mere 0.1–0.2 percentage points during the next five years[30].

Influence of the economy on politics. Current situation and a forecast for 2020–2024

The persistent lack of economic growth may influence political reality in Russia twofold:

- growing disappointment of citizens with their declining living standards may further weaken public support for the Russian government and Vladimir Putin. It will manifest itself in a growing number of local protests of socio-economic or political character.

- dwindling economic resources and shrinking corruption rent, in the light of limited opportunities of business expansion abroad due to Western sanctions, may provoke growing intra-elite rivalry over assets and increase personal risks for those who do not pertain to Putin's innermost circle.

In recent years a visible trend of growing number of local protest actions (including political protests in Moscow that gathered tens of thousands of people during the summer of 2019), as well as gradually increasing society's awareness of political sources of economic problems has been observed. This trend correlates with decreasing impact of the TV state propaganda on Russian public together with growing demand for political and civil rights and socio-political changes revealed by recent sociological surveys[31].

Nevertheless, the likelihood of mass anti-governmental demonstrations across Russia in the coming years still remains low as several factors may effectively hamper any major anti-governmental mobilisation. They include paternalistic mentality and atomisation of the large part of the Russian public, as well as high degree of economic and psychological dependence of the citizens on the state (almost half of the population directly relies on the state budget: among them – more than 46 million pensioners and at least 14 million people employed by the public sector[32], not counting those from the private sector who depend fully on public procurements). In cases of economic difficulties Russians usually embark on a strategy of passive adaptation and individual survival strategies rather than taking to the streets[33]. According to recent surveys by Levada Centre, only about 10% of Russians believe they can significantly influence the course of events in their country; they are also – predominantly – not ready to bear social costs of desired reforms. Moreover, what prevents the increase in protest activity among Russians is their rational fear of repressions along with the lack of an appealing alternative to the existing regime. Demands for systemic changes could pose a challenge to the regime only if they begin to be regularly expressed by the groups regarded as the government's social backbone (so far mostly passive), like public sector employees, pensioners, the working class, and not by the middle class (so far the most active social stratum) calling for the democratisation of the system.

In spite of narrowing down the group of beneficiaries of Russian economic model (due to intra-elite rivalry and growing costs of Western sanctions), the probability of mutiny among business and political elite remains low. The elite members feel ever more uncomfortable about shrinking amount of resources to share and their endangered personal safety due to the so-called 'fight against corruption'[34], however they still perceive the existing system of power as offering them more benefits than engendering costs. What is more, the high level of mutual distrust will most probably restrain the elite members from a 'collective action' against the president.

Against this background any deep systemic reforms remain off the Kremlin's agenda. Although the lack of such reforms will result in gradual and unstoppable degradation of Russian economy and the living standards of the public, such scenario is still perceived by the Kremlin as less risky than an overall transformation of the system which would undermine the vital political and business interests of those currently in power. Instead, the policy of small, tactical adjustments to the system will be continued. In the coming years the Russian government will most probably continue to resort to selective money transfers to the groups of population most painfully hit by economic malaise, and to seeming improvement of the state governance quality as a compensation for lowered living standards. 'The safety net' provided by state financial reserves and raw materials export revenues will most probably create a sufficient room for manouvre for the government to address flexibly the most urgent needs of socio-economic character and to prevent domestic destabilization. As regards the quality of state governance, 'the technocratization' of federal and regional elites (replacement of politicians with easily changeable 'managers') can constitute an effective means of 'crisis management' in a short run, but it will have limited long-term impact on social moods in the light of inherent anti-development features of Putin's regime. Further prevention of major intra-elite turbulence may require the intensification of the 'fight against corruption' in order to discipline the elite members, as well as more frequent turnover of state officials on different levels of the state apparatus.

In the view of the above, unless external factors bring an economic shock to Russia, major domestic turbulence seems hardly probable during Putin's current presidential term. Nevertheless, the growing discontent among the public and the elite can have some impact on the behind-the-scenes bargains over possible power succession in 2024. Increased intra-elite tensions can lower the quality of state governance (including 'the crisis management' in case of local socio-economic emergencies), which in turn may further erode social support for the regime. As a last resort the Kremlin may intensify repressions against its real and hypothetical opponents, however this method of ruling is the most costly and the least effective in the long term. In any case, politically motivated logic of securing the authoritarian regime will continue to have priority over economic calculations at least until 2024.

Conclusion

Russian economic model is designed above all to serve political and financial interests of the ruling elite. Economic calculations and free market rules play secondary role in this game; they are subordinated to the overriding goal which is to maintain and reproduce the current authoritarian system in a long run. Politics and economy are intertwined in a feedback loop where political clout makes it possible to gain economic assets which in turn help to solidify political power. By this logic, political control is regarded by the Kremlin as much more important than economic development.

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Russia's Dependency on the Energy Sector: How Long?

Vladimir Milov

The idea that Russia needs to diversify its economy away from overly dependence on the oil & gas export revenues has been dominating the national discourse for the past decades – as a matter of fact, it had first originated from the program documents of the Communist Party of the Soviet Union, which had realized the negative effects of such dependence since the emergence of "big oil" as Russia's main source of export revenues in the 1970s. Massive government rhetoric on this issue has yielded zero practical results – instead, as shown above, Russian dependence on oil & gas revenues has grown in the past 20 years by some key criteria (see below for details). This can be easily explained by the fact that Vladimir Putin's system of governance clearly benefits from significant oil & gas export revenues, and moreover, its sustainability depends on it – cash from energy exports allows building substantial financial reserves which are key to maintaining stable macroeconomic environment and financing state-sponsored investments, or so-called "national projects" (major priorities of Putin's government economic policy), plus to enrich Putin's cronies who have built their businesses and personal wealth on redistribution of oil & gas rents. So, there's, in fact, a little practical motivation for Putin's government to change the oil & gas status quo. In rhetoric, everybody in Russia is constantly talking about the need to diversify the economy and reduce energy dependence – in reality, majority of the elite is happy with the status quo, so little changes occur.

Real life, however, presents new challenges to the oil & gas dependence paradigm that is currently dominating Russia. First, the growing global competition in the oil & gas markets has wiped off larger part of the super profits that Russia used to enjoy back in the 2000s when the current political and economic systems had originated. It is hard to imagine a scenario under which oil prices will come back to the level of above \$ 100 per barrel for a prolonged period of time, and Gazprom currently sells natural gas to Europe at \$ 200–250 per tcm, not the \$ 300–400 anymore which it used to enjoy ten years ago. Competition, which is driven by the shale oil & gas revolution in the U.S., development of global LNG trade, European Union policy of reforming its energy markets – is a long-term sustainable factor, which won't allow returning to the rent-seeking model of Russian economy build in 2000s. Oil & gas sector is not a source of super profits and rents to the extent it used to be, and will never be again.

Second, new strategic threats are looming: the prospect of fast replacement of internal combusting engines (ICEs) with electric vehicles (EVs) in automotive transport raises the prospect of "peak oil demand" – fundamental changes in the global oil market which will end the era of relatively expensive oil due to falling automotive demand for forever. This issue is discussed in more detail below, but the experts are currently arguing mostly about "when" the EV revolution in automotive transport will create a glut at the oil market and put an end to expensive oil – 2025, 2030, and 2035 – but not "if" this is going to happen, which is more or less a certain perspective now. Russia seems to be totally unprepared for this kind of situation, which has a potential to serve as a replica of oil price collapse of 1985 – that has contributed greatly to the collapse of the Soviet Union.

These two trends at the international energy markets – growing competition and looming demand revolution – may have profound effect not only for the Russian economy, but also for the whole model of the current Russian state and system of governance, as it would most likely deprive Russia from significant oil & gas export rents, the control over which and redistribution of which is the essence of the system built by Vladimir Putin during the past 20 years.

This pressure is also complicated by the third problem – Russian oil & gas production is getting more expensive over time, as traditional mature fields become depleted, and the production moves to regions with substantially higher costs. This is also a game changer of sorts: the Russian government already has to provide huge tax discounts to oil & gas companies to develop new fields, which will inevitably bring down budget revenue from the oil & gas industry in the coming years as production from new, more expensive fields replaces relatively cheaper output from matured Western Siberian fields (this issue is discussed below in more detail).

All in all, the rent-oriented model of the Russian state built during the past 20 years is already dead. Even though it technically lingers on, some important new signs of change are visible on the surface:

- Russian Federal budget for 2020–2022[1], country's main financial guideline document (currently undergoing a process of adoption by the State Duma which is supposed to be finished by end-November), envisages unprecedented fiscal consolidation under the currently enacted "budget rule", which is basically explained with the fact that the country needs to prepare for harder times and consolidate the available modest rents (from relatively modest-priced $ 60/barrel oil and $ 200+/tcm gas) in the "rainy day fund", instead of spending this money today for development purposes;

- Gazprom's biggest construction contractors and Putin's closest cronies, Arkady Rotenberg and Gennady Timchenko, have either sold or are in the process of selling back to Gazprom their lucrative gas infrastructure construction businesses[2], which have delivered them generous profits in the past 10–15 years, meaning that they don't see a perspective for major new rents in form of capital expenditure spending on construction for the coming years anymore.

These issues are considered below in more detail, but the bottom line is that even the key actors in the Russian elite are preparing for the worst.

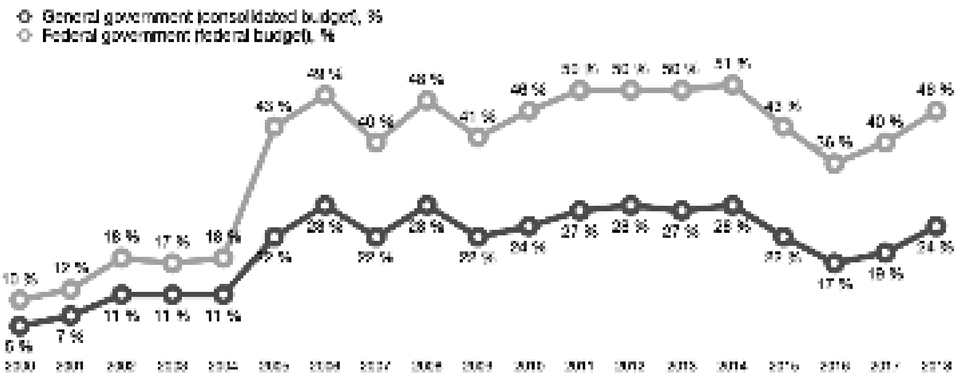
However, in terms of open public recognition of the oil & gas dependence challenge, Russian elite is remarkably falling behind and is not truly catching up with the real-world developments. Despite some alarmist voices[3], there's a lot of denial potential new challenges to the current rent-oriented model, and the key political figures continue to reiterate the old mantras that "the world won't be able to go on without the good old hydrocarbons" and that the newly emerging trends – be it competition from shale oil & gas or growth in renewable energy production or the perspective of EV revolution in automotive transport – are "a bubble" (see separate paragraph below on such a denial of future energy market trends). This has the capacity to lead Russia into a major economic crisis connected with collapse of the oil & gas revenues in the coming from medium to longer term period, to the similar magnitude as compared to the collapse of the international oil prices since 1985, which had eventually contributed to the fall of the Soviet Union.

Assessing Russia's current dependence on the oil & gas sector: how much?

There are different criteria which can be used to assess the actual dependence of Russia on the oil & gas sector. Frequently, a share of oil & gas industries in GDP is used, which looks quite modest in nominal terms. Russian oil & gas industries make up just about 8–10% of the Russian GDP (depending on oil price fluctuations). However, some economists argue that not all of the value added generated by the oil & gas sector is accounted for through such a direct count, and part of it is counted as "trade operations", which allows to estimate the real share of oil & gas in GDP as not less than 25% (see "Potemkin's GDP" by Christof Ruehl and Mark Schaffer[4]).

In reality, two other factors illustrate Russia's deep dependence on the oil & gas revenues better than the GDP share merit: the share of oil & gas related income in government budget revenue and the share of oil & gas in total exports. The first one in total budget revenue shows how deeply the stability government's finances is dependent on income from oil & gas industries, and how vulnerable Russia's budget is to potential oil & gas price shocks. As can be seen in graph 1 below, the dependence is particularly strong for the federal government budget: after the taxes on the oil industry were significantly raised in 2005, the share of oil & gas revenue in the total federal budget revenue was always within 40–50% range, as opposed to 10–20% in the early 2000s, when oil prices were low, and the level of taxation of the oil industry was relatively modest. Similar picture exists for the "consolidated" budget (budget of the general government that includes not only federal budget, but also regional budgets and budgets of tax-financed state funds like Pension fund and medical insurance fund): since 2005, the share of oil & gas revenues has stayed within 20–30% range as related to total income of the consolidated budget, as opposed to 5–10% before 2005.

Graph 1: Share of oil & gas budget revenues* in Russia's state budget in 2000–2018



** Includes mineral extraction tax for hydrocarbons and export duties for oil, gas and petroleum products from 2004 onward; sum of various taxes on mineral resources production and export duties before 2004.*

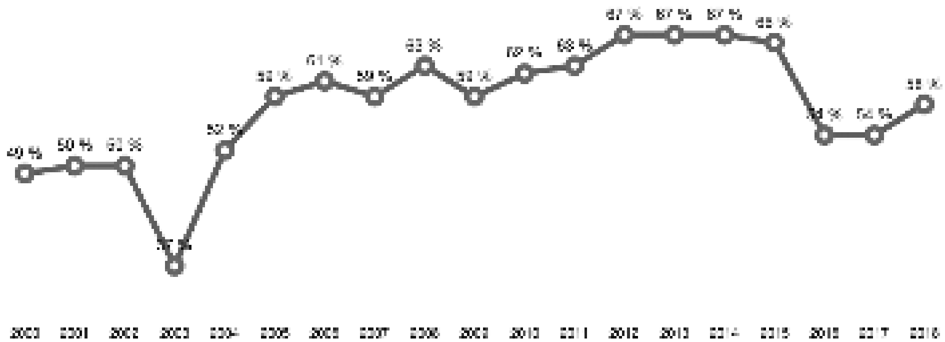
Sources: Rosstat, "Russian Statistical Yearbook"; Federal Treasury, data on yearly consolidated budgets.

As can be seen from the graph 1 above, the dependence of Russia's government finances on the oil & gas revenue has grown considerably since early 2000s, despite all the rhetoric of Vladimir Putin's government about the need to "diversify the economy" away from the overly dependence on energy industries.

Share of oil & gas revenues in Russia's total exports is even greater: as can be seen from graph 2 below, since 2004, it had stayed within 50–70% range, fluctuating along with the level of international oil prices, but always exceeding

50%. This is also essentially higher than the beginning of 2000s, when the share of oil & gas revenues was 50% or below, which is another indicator showing increasing dependence of the Russian economy on its energy sector under Vladimir Putin.

Graph 2: Russian oil & gas exports* as % of the total exports, 2000–2018



** Includes revenues from exports of crude oil, petroleum products, piped natural gas, and LNG.*

Source: Russian Federal Customs Service, "Exports of Crucial Goods from Russia".

Extremely high share of oil & gas revenues in exports is important since it makes the current accounts balance overly dependent on the fluctuations of the oil & gas prices. Sharp drop in prices may cause significant devaluation of the Russian currency, the ruble, which undermines consumer purchasing power (since Russian consumer market is still significantly dependent on imports of consumer goods and materials for their production) and leads to decline in real household incomes – as have happened since collapse of the international oil prices in 2014 (Western financial sanctions depriving Russian companies and banks of opportunity to borrow at the international financial markets have also contributed, but the effect of the oil price decline was obvious, too).

Given the figures shown above, it is clear that the dependence of Russia on the oil & gas export revenue is critical for some major elements securing the stability of the country's economic system: the sustainability of government's finances and ruble's exchange rate are both critically dependent on the inflow of oil & gas money into the country.

Such critical dependence is actually the one reasonable explanation behind the Russian Government's somewhat awkward budget policy of the moment (which is also sealed in the newly adopted federal budget for 2020–2022[5]): the Government seems to be very much ready to tolerate the slowdown of economic growth to below 2% on the background of significant tax increases (increase of VAT rate from 18% to 20% in 2019 and other tax increases which add to permanently growing tax burden on the economy) at the time when budget maintains strong surpluses (a total RUR 4 trillion surplus is envisaged for the federal budget for 2020–2022[6]). Russian economic Minister Maxim Oreshkin openly admits why such policy is been carried out: to get prepared for the situation when the oil prices fall to $ 40 per barrel or below, even at the expense of slashing economic growth rates[7].

Risks and challenges

Major future risks to the Russian economic system over reliant on oil & gas export revenues were briefly listed above, and below we consider them in more detail.

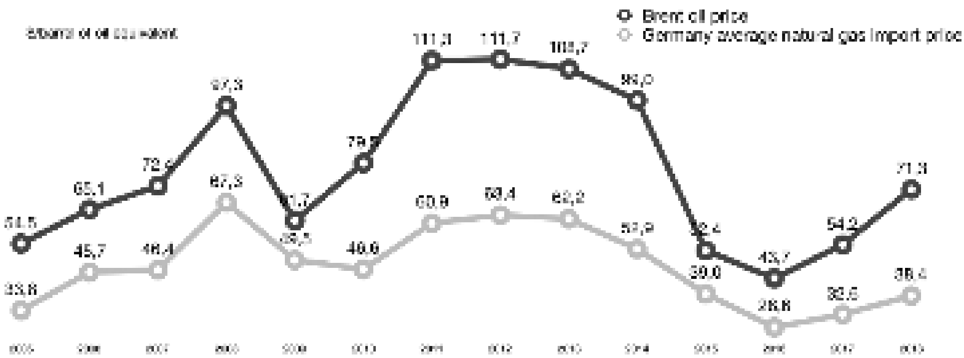
Competition at the global energy markets: No more super profits

Basic approaches to the current economic policy (first of all, budget system built on extracting excessive rents from the oil & gas industry) have emerged during the era of historically high oil prices, when the price of a barrel was above $ 100 or near. However, as we have seen since the oil price collapse of 2014, any attempts to bring the oil prices back near that levels are failing due to fundamentally changing situation at the global oil market. Since the U.S. shale oil revolution, a new major player has emerged at the international oil market (American shale oil producers) which only benefit from any efforts to artificially hold back oil output by Russia and OPEC, and keep pumping more oil. This supports the glut at the international oil markets and prevents prices from ever coming back closer to $ 100 per barrel: growth in prices opens the opportunity for further increases of shale oil output, which replaces cuts by OPEC and Russia. The spectacular failure of the OPEC-Russia oil output cut agreement of 2016–2019 to bring oil prices to higher levels again illustrates just exactly that mechanism. (Graphs on the dynamics of the international oil price and U.S. shale output can be provided if necessary, but I don't think they're particularly relevant for this paper as these developments are well known.)

Another factor is the increased competition at the European natural gas market (which will remain key target market for the Russian gas for decades) which has led to significant decoupling of gas export prices from the oil prices, and revenues from gas exports shrinking even to a greater extent as compared to oil. Graph 3 shows how the differential between European gas import prices and Brent oil prices has increased: whereas in 2006–2010 prices of oil at

$ 60–70 per barrel have corresponded to natural gas import prices in Germany at the level of $ 46–50 per barrel of oil equivalent ($ 280–305 per tcm), in the recent years, German gas imports prices have never exceeded $ 40 per barrel of oil equivalent (or were below $ 250 per tcm).

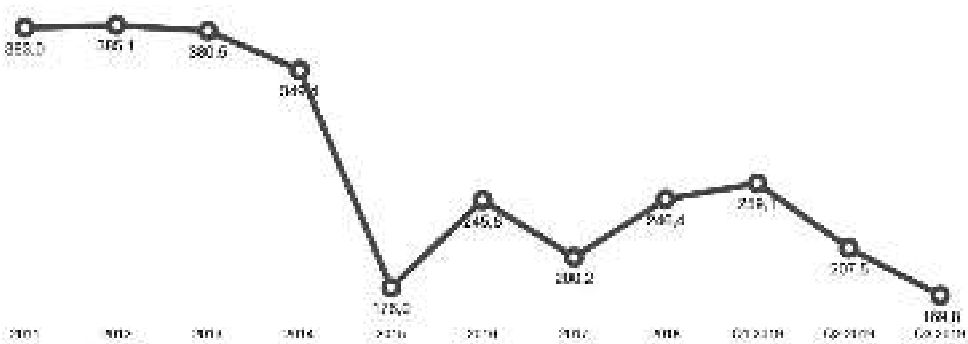
Graph 3: European natural gas prices are less linked to oil than they used to be



Source: BP Statistical Review of World Energy 2019.

Graph 4 shows that Gazprom's average gas export prices to Europe in the recent years have never been able to recover to a level above $ 250 per tcm, as opposed to $ 350–400 per tcm range that Gazprom has enjoyed back in 2011–2014:

Graph 4: Gazprom's average European gas export price, $/tcm



Source: Gazprom's IFRS financial reports.

As a result of that, Gazprom has been recently reporting shrinking profits due to weak gas exports prices, despite the record sales of gas to Europe in terms of volumes[8].

All this means that Russia may never again see the super profits from exporting oil & gas at the levels it had before 2015, when oil was above $ 100 per barrel, and the amount of revenues from oil & gas exports would remain relatively low by the standards of the past 15 years.

Into the renewable energy future: "Oil shock" is on the way

Yet even another looming challenge is the potential oil demand revolution which may not only bring the oil prices further down, but actually put them under an eternal cap, when we shall never again see oil above $ 30–40 per barrel, with the prospect that prices may fall to even lower levels. Currently, main consumer of oil is the transport sector, and about 60% of the oil consumption by the transport sector is automotive demand. However, here we see a process of rapid replacement of the internal combustion engines (ICEs) with electric vehicles (EVs), which at some point may lead to the situation when EVs would eventually begin to dominate the global automotive sector, the largest oil-consuming sector by far, leading to collapse of demand for petroleum products. Such a prospect in the recent years has intensified the discussion about "peak oil demand" – a turning point for the global oil market when international demand for oil will stop to grow, and will only begin to decline further. Oil will still continue to be in demand for some extent, but peak demand will lead to emergence of a significant oil glut at the markets which will lead to oil price collapse.

There's a discussion among economists and industry experts as to when such an EV revolution in the automotive sector will happen, and it is beyond the scope of this paper to discuss this issue in detail. However, despite the fact that most oil companies expect demand to peak between the late 2020s and the 2040s, and the International Energy Agency does not expect a peak before 2040, forecasts exist that EV revolution leading to peak oil demand may be as close as mid-2020s[9].

In any case, recognition of looming peak oil demand is becoming a mainstream in the global oil markets and, as usually with the technological revolutions, conservative forecasts have a chance of not living up to the actual reality. Russia has to be prepared for that – given the fact that it had already experienced similar oil export revenues collapses in the past (in the 1980s). Some of the members of the Russian elite seem to recognize these risks. For instance, German Gref, former economic Minister and key driver of the economic reforms of the 2000s, currently chairing Russia's biggest bank Sberbank, has been increasingly focusing on the looming "oil shock" for the Russian economy, bringing oil prices below $ 40 per barrel in his public speeches[10].

In denial: Russia's rulers just don't realize the seriousness of the problem

Despite the some levels of recognition of potential oil shock looming and its dire consequences to the Russian economy (see the reference to German Gref's remarks mentioned above[11]), generally, Russian authorities are in deep denial of the dangers that lay ahead. In their public speeches, top decision making figures continue to repeat the following mantras, which are becoming irrelevant by the minute:

- That "abandoning hydrocarbons is dangerous for the civilization" (recent speech by Vladimir Putin[12]);
- That renewable energy is strategically not competitive, its prospects are exaggerated and it harms the environment (also Vladimir Putin[13]);
- That prospects of rapid expansion of EVs in automotive transport are exaggerated and oil would continue to dominate in the next 20–30 years (Igor Sechin, CEO of oil company Rosneft[14]);
- That the U.S. shale oil & gas revolution is "a bubble" and will not be able to sustain itself (Vladimir Putin[15] and Gazprom's CEO Alexey Miller[16]).

This denial is not just rhetoric. It is actually reflected in the government's practical policy, which is still currently aimed at accumulating significant financial reserves for years to come, basing mainly on the income from oil & gas export revenues, and at attempting to revive the Russian economy not through encouraging private investment, but mainly through massive state-financed investments through the so-called "national projects" (source: materials for the Federal budget for 2020–2022[17]). The funding for these "national projects", to a larger extent, is also expected to come from the oil & gas export revenues. The development of alternative sectors of the economy (manufacturing, high-tech), which can potentially substitute oil & gas in the future, is not particularly successful, because it is not built on encouraging private initiative, private investment and international competitiveness, but instead on injecting some oil-related money into a narrow number of state-appointed monopolies – an approach which will never work, as explained below in more detail.

Such policy approaches put Russia in grave danger in the face of the above explained potential future developments which have the potential bring oil & gas prices even further down, and totally deprive Russia of the oil & gas rents which it had enjoyed before, and on which its current economic system is essentially built. Apart from destabilizing the budget system, falling oil & gas export revenues will also cause further devaluation of ruble, hitting domestic consumer purchasing power and constraining economic growth (how these effects have worked in 2014–2016 is explained in the working paper "The Russian economy IN FOCUS: recovery is further away than some might think" published by the author of the present paper in 2017[18]).

Alternative reality: is Russia prepared?

What Russia would do if it experienced oil & gas price shock as explained above? What else can Russia produce besides oil & gas? Does it do anything to diversify its economy away from the overly dependence on its energy sector?

One can't say that there have been made no attempts to develop the alternative sectors of the economy. However, they all have turned to be mostly unsuccessful, and for a very clear reason: Vladimir Putin's economic model, instead of stimulating private initiative, private and foreign investment, competition, private sector-driven innovation, instead focuses on development of "strategic sectors" by appointing a dominating player (essentially, a monopoly), often state-owned (which undermines the effectiveness of its governance), creates huge barriers for outsiders for entry in these sectors, and forces other state-linked companies to buy its products (thus eliminating stimulus for the non-oil & gas products to be competitive – the state players will be forced to buy them anyway, so why bother). The classical examples of the recent attempts and failures of that kind include:

- Civil aircraft manufacturing. In the early 2000s, Russia has scrambled several competing projects for developing new civil aircraft, and appointed one project, Sukhoi Superjet (SSJ) aircraft, to be country's flagship aircraft manufacturing effort. Competition was eliminated, massive state aid was injected into the project, and domestic airlines were forced to buy SSJ aircraft. Result: SSJ failed to market internationally due to operational ineffectiveness and failures in maintenance and spare parts delivery system, currently has no international marketing prospects, the very few international consumers which dared to purchase it are now returning the remaining aircraft back[19], and project's survival depends solely on forced orders to buy more SSJs for the Russian state-owned airlines (Aeroflot and corporate airlines of ministries and state-owned companies).
- Shipbuilding. Putin's Government has been announcing plans to massively develop shipbuilding sector in Russia since the early 2000s, but these plans have never materialized, the country is not on the radar screens among major players at the international shipbuilding markets. Most recent effort includes development of the Zvezda wharf in the Far East sponsored by Rosneft, which has received massive aid from the National Weakth Fund and is intended to substitute the imports of vessels and offshore platforms for the Russian oil & gas industry. However, at this moment Zvezda has failed to market any of its vessels internationally, and its portfolio of contracts is still far short of the project's profitability target, and only consists of contracts with the Russian oil & gas

producing companies or state agencies[20] which were forced to conclude them under the direct pressure from the authorities, including Vladimir Putin personally[21].

- Agriculture and food. Russian Government has put high hopes into development of import substitution in the agricultural and food industries after a self-imposed food import embargo for the Western nations in 2014. However, although some notable import substitution has indeed happened at the Russian food market since then, it hadn't resulted in emergence of internationally competitive food exporters, and domestic market import substitution was associated with loss of effectiveness and growing prices[22]. Russia continues to export only most primitive agricultural products like wheat or sunflower oil. The newly emerged "national champions" in food production, like Miratorg, were also heavily subsidized by the state, failed to successfully enter the international markets, and their growing domestic supplies have mostly resulted in growing prices for the international consumers[23].
- ICT goods. Despite the vast intellectual and cadre potential (a very significant number of Russians are actually employed by the ICT goods producers worldwide), Russia is non-present at the international ICT goods market. By share of ICT goods exports in total goods exports, Russia stands among the worst nations in the world – just 0.6%, as opposed to over 5% for the European Union, 9.5% for the United States, 11.7% world average, and over 27% for China[24].

To sum up, in the economic system built by Vladimir Putin – highly monopolized, with huge barriers for private initiative and competition and heavy involvement of ineffective bureaucracy – it is almost impossible to expect that any other sectors of the economy apart from the oil & gas will be able to develop internationally competitive products in the nearest future. Domestic market, as can be seen from the examples of Sukhoi Superjet, shipbuilding industry, agricultural and food industries, are too small to create meaningful sectors significantly contributing to the development of national economy. In other words, to create large competitive sectors beyond just oil & gas significantly contributing to the GDP, Russia needs access to export markets with competitive products – mere "import substitution" by force of government-imposed barriers and state aid just isn't enough, and is counter-productive in terms of wrong incentives created by monopolization and strangling private initiative and competition. Highly monopolized, state-controlled and overly regulated economy just can't deliver internationally competitive products, as we have been able to see across many sectors of the Russian economy in the past 20 years.

The usual complaints of the Russian authorities on "high entry barriers" to the international markets "imposed by the developed nations" are just lame excuses.

There have been very successful examples of development of such industries across the globe beyond just the developed world in the past 20–25 years. Brazil was able to produce the world's third largest aircraft manufacturer, Embraer, from scratch – after it was nearly bankrupt 25 years ago. Philippines and Vietnam were able to make it into top 5 of the world's biggest shipbuilding nations. Countries with the largest shares of ICT goods exports as % of their total exports[25] are Hong Kong, Philippines, Singapore, Vietnam, Malaysia, China, etc. All these successful cases have included opening the relevant industries to private capital, foreign direct investment, aiming at international competitiveness as opposed to creating "sheltered" territory for the monopolies by ordering the economic agents to buy their products by force (as Russia does). Putin's economic policies of the past 20 years have been the exact opposite of creating internationally competitive industries.

Conclusion

It is not easy to predict, whether Russian economic policy approach would change in the future or not, in order to address the looming "oil price shock" challenge and to develop competitive non-oil & gas industries, as it much depends on the political changes in Russia. Under the current Putin's system, it is very hard to foresee a reversal of the economic policies aimed at creating barriers and transferring the whole sectors of the economy under the control of a handful of state-affiliated monopolies. Moreover, the very economic policy currently seems to be captured by these monopolies, which clearly stand behind the idea of "national projects" – currently the main economic policy idea of the Russian Government, which is essentially about giving these state-affiliated monopolies more taxpayers' money, so they can finally build something. As we have seen from past couple of decades, there's no chance that such approach will work, which is already openly doubted even by some top people within the Russian authorities, including the above mentioned German Gref[26].

This means that Russia remains very much open to the threat of either an outright "oil price shock" similar to that of the 1980s, or, at least, to continuing permanent contraction of the oil & gas super profits due to increasing competition and slowing demand. What are the consequences? Current Russian official forecast for 2020–2024 incorporated into the Federal budget for 2020–2022[27] envisages a scenario under which Urals oil price will not exceed the range of $ 43–46 per barrel ("conservative scenario"). This scenario envisages that the annual GDP growth will not exceed 2.5% per year to 2024, and that real household incomes growth will not exceed 2% per year. Obviously, oil slipping below $ 40 may mean worse scenarios, including outright contraction of the economy for years to come, heavy devaluation of ruble and declining real personal incomes for years ahead, budget deficits which will erode already accumulated financial reserves, and the whole set of other negative economic consequences. The current economic policy seems all too ignorant of these challenges and prospects, which strategically weakens Russia for decades to come.

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Putin's Vertical and the Regions

Dmitry Oreshkin

Both supporters and critics of the Putin regime usually overlook one of its important attributes. This is an endless conflict between the priorities of the authorities, seeking to consolidate resources in the Center, and the need to develop other territories, which, on the contrary, undermine the material basis of the authorities themselves. One wall of the corridor is set by the subjective desire to dominate, the other by the objective degradation of the socio-economic environment.

Hence the state management's oscillatory trajectory within this corridor of values, which looks like an alternation of the eras of centralization and decentralization. In terms of economic geography, the process is described as a change in the 'sectoral' method of managing the economy to the 'territorial' one and vice versa. The sectoral approach involves the concentration of powers and administrative institutions in the capital, from where ministries and departments manage the activities of their specialized enterprises (often located thousands of kilometers from Moscow) and have little care about the development of the regions where these enterprises are located. The territorial approach, on the contrary, seeks to transfer powers 'onto the spot' for the sake of comprehensive land optimization.

The cycles of centralization coincide with periods of political and economic mobilization, the strengthening of autocracy. The territorial approach acts as a forced reaction to the impoverishment of territories and reduction of their economic returns. The problem is not unique in world practice, but it is especially acute for Russia with its enormous size. In the political dimension, these cycles are close to the alternation of the phases of 'freezing' and 'thaws'. The process can also be described as a change in the phases of unitarization and federalization.

In 1917, Lenin and Trotsky, seizing power over a country with the fastest industrial growth rates[1] and a huge (despite the devastating consequences of the First World War) economic, territorial, demographic and infrastructural potential, began with unlimited centralization, mobilization and predatory seizure of resources from inhabited territories. Their goal was to strengthen the dictatorship of the proletariat for the further development of the World Revolution. Bourgeois Russia was perceived by them as an object of conquest and submission, its management was carried out by decrees of direct action and repression. There was no question about any territorial development and, especially, investment in the regions.

By 1922, devastated territories lost the ability to feed not only themselves, but also the Bolshevik nomenclature. The threat of losing control of the army (the pillar of the regime) and mass famine forced the revolutionary leaders to think about the New Economic Policy (NEP). In fact, it was a rather 'old' one – with partial restoration of property rights, market relations, convertible currency and investment interest. The period of total power administration and hyper-centralization of 1917–1922, reaching material limits, ended with the unexpected Leninist directive: "*Do not dare to command!*" For the Bolshevik managers this was a shock: they knew nothing but command.

But the economy advanced. 1924–1925, the first year after a real turn to the NEP and the advent of the 'gold dime', yielded a 57 percent increase in industrial production (up to 4.9 billion rubles) compared to 1923–1924. Consumer market prices decreased by almost 20 percent, labor productivity by 1925 reached the pre-war level, as well as real wages. By 1926, the total volume of industrial production rose to the pre-war level[2]. As for agriculture, the monstrous Leninist famine receded already in 1923. In 1925, as Nikita Khrushchev writes in his memoirs about Yuzovka (present-day Donetsk), "In the autumn there was literally a bounty of goods and agricultural products – vegetables, watermelons, melons and poultry... And all this wasis cheap. The standards for prices were maintained then on the pre-war level. Before the war, a pound of meat cost in Yuzovka and vicinities 15 kopecks. It cost 15 kopecks also in 1925 and in 1926. Until 1928 there was an excess of meat"[3]. The second half of the 1920s, right up to the start of collectivization, was accompanied by a boom in the delayed births. The population increased on average by 3.5 million people per year.

Naturally, the Soviet government cannot reconcile itself with such a course of events. Monetary resources in the form of a hard currency are flowing from the hands of revolutionary dictators into the hands of private entrepreneurs, who, firstly, are more active and resourceful, and secondly, unlike the party, produce products oriented to solvent demand. What if not food is the primary subject of effective demand? With each economic turnover, the 'class enemy' accumulates financial resources, the economy reorients from mobilization rails to market-consumer ones. Economic decisions go from the hands of the Party Center to the local entities: the private entrepreneur develops business where it is more convenient for him, and not where directives order him to. The space for administrative-power outrage is narrowing. The Bolsheviks and the Chekists feel like a fifth wheel in a coach on the side of the road. Industry produces what the consumer market needs (it mainly needs food products, clothing, building materials) instead of what the dictatorship wants (it needs weapons to export the revolution). In addition, the Soviet government, unlike the private trader, is not able to present solvent demand for its strategic interest. Insolvent demand – as much as you like, but you won't get carried away with a private produce... In short, it is a defeat of the Bolsheviks in competition for material resources. And with that, in accordance with the Marxist dogma, in competition for power.

In administrative terms, this is manifested in the reduction of the role of centralized special services. On 6 February 1922, at the same time with the decision to switch to the NEP, the Cheka was transformed into the GPU (Chief Political Directorate), which was accompanied by a sharp drop in the number of 'organs'. On 15 November 1923, the GPU under the NKVD (Commissariat of Internal Affairs) was transformed into the OGPU under the Council of People's Commissars (the Soviet government). If at the end of 1921 the main Soviet special service had 90 thousand official operatives, then by the time the GPU was formed, their staff had been reduced to 60 thousand, and by 1 November 1923 to 33 thousand. The number of 'seksots' (secret employees), during the initial period of transition to the NEP (1921–1923) decreased from 60 to 13 thousand[4]. Stalin was the System reply as well as a new wave of repressions and hyper-centralisation.

The next Soviet-style half-cycle of the weakening of centralism begins after the death of Stalin and is associated with the name of Khrushchev (as well as the undeservedly forgotten Georgiy Malenkov), when the collective farmers were allowed to increase the area of their personal plots several times and the tax pressure was reduced. At the same time, the redistribution of power in favor of the regions takes place: territorial economic management bodies are formed – the so-called Sovnarkhozs (1957) – essentially regional governments. The reaction to the concessions is a new surge in economic growth – along with frightening signs of territorial independence. Khrushchev, a loyal disciple of the Leninist-Stalinist apparatus school, is trying to sit on two chairs. He wants to unleash the local economic initiative, reduce the bloated armed forces and bureaucracy, improve the living conditions of the people (mass construction of five-story apartment buildings) and at the same time strengthen the authority of the party and the consolidation of resources. A striking example is the centralized campaign imposed by him for the mass introduction of corn along with a very expensive program of militarization of space. Curtailment of economic growth in the late 1950s, the grain crisis of 1961–1962, the brilliant flight of Gagarin into the outer space, and the hunger riot in Novocherkassk, which was bloodily suppressed in a typical Bolshevik manner are contradictory results of the epoch.

The party-power apparatus finds a way out of the ambiguous era in a palace coup, with abolition of the local economic councils and the establishment of a more centralized Brezhnev model with emphasis on improving the living standard of the nomenclature and population. The great luck with the discovery of oil fields in Western Siberia allowed this version of industry management to stay afloat for almost twenty years.[5] But in the end, even against the backdrop of oil abundance, stagnation, shortages of commodities, inflation, and resentment among the population emerge amid growing claims to the Center.

The capital, which is swelling by leaps and bounds, serves as a constant source of concern for the top party leadership, which with one hand tries to restrain its growth with the help of administrative bans and issuance of residence permits, while with the other brings into the city the so-called 'limiters' – working hands from the provinces, attracted by branch departments according to the agreed limits for construction, transport, utilities and other works. Hypertrophy of the Soviet capital is a logical consequence of the super-centralization of political and economic life, when other cities are obviously unable to compete with the Center in terms of economic and sociocultural comfort.

The story ends with a half-restructuring, similar to the Khrushchev's model, when the upper elites (including the KGB leadership in the person of Yuri Andropov), became convinced of the futility of tightening the screws, and once again tried to fix the 'vertical' with the hands of the 'vertical' itself. An unexpected, but logical result was the collapse of the unified political space due to the Center's shortage of material, ideological, organizational, human and even power resources. The trouble came from where nobody expected.

Having 63,900 tanks (more than the rest of the world altogether!), the Soviet government was not able to use them either to maintain power control over the political space, or to combat the economic crisis. In particular, since it had nothing to feed the tanks' crews. As for Lenin in 1922, there was nothing left to feed the Red Army.

On 16 January 1991, the USSR Deputy Minister of Defense V. Arkhipov asked the Kremlin leadership to allocate him 8 million German rations for distribution to Soviet militaries and their families. The bitter irony is that those rations (*daily ration of military personnel*) were sent to the USSR by the Bundeswehr – a strategic adversary – as humanitarian aid.[6] Three days later, Arkhipov asked for an additional transfer to the Ministry of Defense of another seven thousand tons of long-term storage bread in tin cans received from the Bundeswehr. If military personnel and members of their families suffer from a shortage of products (the subject of primary party concern in the system of Soviet priorities), then there is nothing to say about ordinary citizens.

The next cycle of forced decentralization spun out of control due to subjective (Gorbachev's indecisiveness, ambitions of regional leaders) and objective (deep-rooted false ideas about the structure of the economy, shortage of qualified personnel, inflation, militarization, the collapse of communist ideology, the war in Afghanistan, dropping oil prices, etc.) factors. The result was the collapse of the USSR.

Putin's counter-reform

After a surge of regional anarchy of the 1990s (and simultaneous market reforms as saving tool), the renewed and rejuvenated nomenclature presented the reins of power to Vladimir Putin, who, according to the standard scenario, began with centralization. The end of the 1990s and the beginning of the 2000s, in addition to structural reforms, the transition to market economy, to private property and convertible currency, dragged the country through a series of technological revolutions that were fundamentally impossible in the 'forbidding' ideological environment of the USSR: mass computerization, introduction of cyber technologies, the Internet, mobile telephones, individual motorization, etc. Another imperceptible revolution was the liberation of the cities that became more vivid and began to shake off the long Soviet stagnation. Since the renewal was accompanied by the collapse of the previous industry branches, focused almost entirely on the military industry, the cities (especially not the largest ones) experienced a painful phase of structural decline before the new post-industrial upswing.

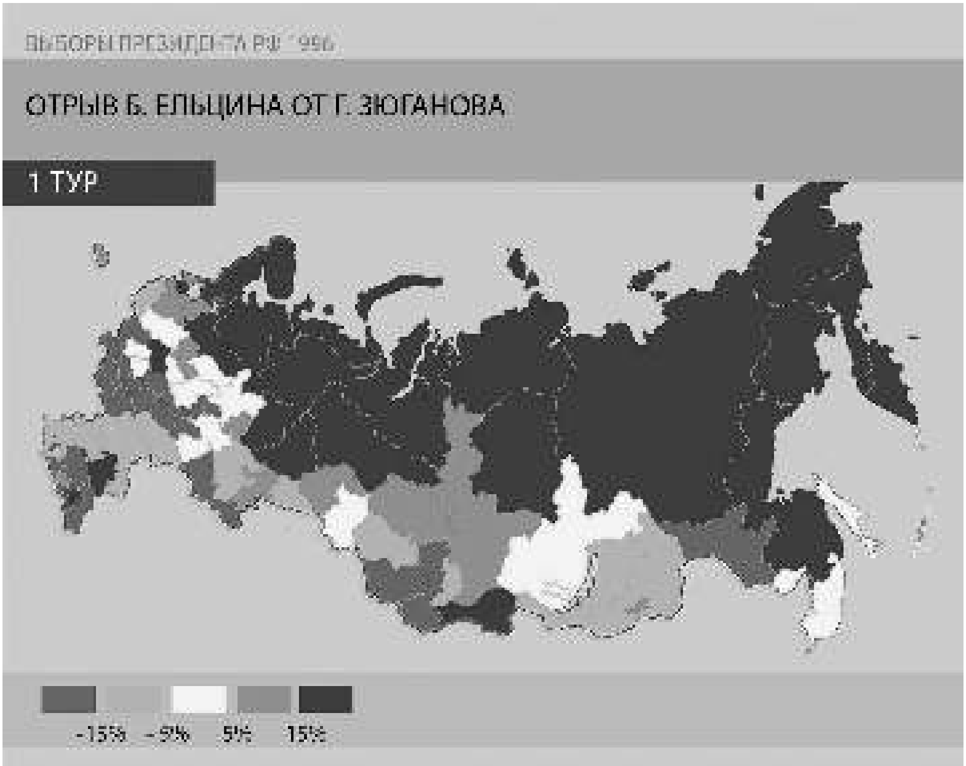
Modernization spread in accordance with the classical law of the spread of innovations – from the capital region (in our case, Moscow) through the largest secondary urban centers – and then farther on up to fading out on the conservative periphery. In the super-asymmetric socio-economic space inherited from the USSR, the gain from renewal naturally concentrated in the capitals. Peripheries (both social and geographical) did not have time or could not receive noticeable bonuses. It is clear that it became the supporting zone for the new nomenclature revenge, which delayed and even reversed the barely begun growth of second-level cities. The reforming of the Russian universe along the track of European values once again turned out to be incomplete and half-hearted.

Liberal reforms from the very beginning were understandable and fruitful only for urbanized and Europeanized (or rich in raw materials) regions with a total number of less than a third of subjects of the Federation. Most of the regions, including ethnic autonomous entities ('national outskirts' in terms of the Soviet era), were and remain deliberately uncompetitive. The reforms of the 1990s meant for them only an even more pronounced lag behind the leaders. Discrepancies in the size of the tax base among the regions amounted to and still are measurable in dozens of times.

Differences at the municipal level are even more catastrophic. In cities (this is especially true for almost 400 so-called 'single-industry towns', built in the Soviet era around one, most often military, factory), the chances of getting out of poverty without outside help are close to zero. The return to centralization and the supreme redistribution of resources was caused not only by the desire of the apparatchiks and security forces to regain their status and strengthen control, but also by the natural desire to bridge the growing gap between the territories. The fear of another split was very great – especially against the backdrop of the conflict in Chechnya, which spanned the entire second half of the 1990s.

'Collective Putin', perceiving reality through the prism of Soviet priorities, was doomed to return to unitarianism. The process of counter-reforms originated in the Kremlin – and could not help but arise because of the effect of path dependency. If not Putin, then Luzhkov, Primakov, especially Zyuganov or Lebed – any of the real contenders for power after Boris Yeltsin would have followed the same path. At the same time, the backward vector received the most powerful electoral support on the remote periphery – in fact, on the same lands that at the beginning of the 1990s served as the supporting zone of Gennady Zyuganov and the old party nomenclature.

Graph 1: Presidential elections 1996 in RF. Presentige gap between votes for Yelstin vs Zyuganov 1ST round



Graph 2: Support for United Russia. Persentage of registered voters. St. Petersburg – 13%, Moscow – 13.3%

The so-called 'red belt' of the most conservative communist regions of the mid-1990s model, twenty years later, in 2016, was transformed into a 'blue belt' of consolidated support for Putin and his party United Russia.

In 1996, Boris Yeltsin was the president of the largest cities and the most urbanized and Europeanized (in terms of values, not in geographic sense) territories; the head of the Communist Party, Gennady Zyuganov, on the contrary, was more likely a 'president of the province', including the ethnic autonomies. By 2016, the 'party of the province' was United Russia with Putin as its informal leader. As always with regional analysis, there are several territories that do not obey the general rule – but it would take too much time to analyze each specific exception and its reasons.

Due to the inertia of territorial processes, the negative economic consequences of the restoration of centralism-verticalism made themselves felt only in the second half of the 2000s, after the crisis of 2008–2009. Prior to that, the renewed Russian economy was growing steadily at a pace of 5–7 percent per year. Which, of course, was contributed by a steady increase in world prices for hydrocarbons. After the crisis, the growth rate decreased to 1.5–2 percent, which was considered by the Center as an acceptable price for unitarization and restoration of political control.

The reaction of the regions

The regional response to the 2009 economic crisis was rather interesting. The independent economic campaign of FBK (Financial and Accounting Consultants, not to be confused with FBK by Aleksey Navalny – Anti-Corruption Foundation!) In the analytical report *Priorities of Regional Budgets – 2010* notes the general features of the economic strategy of the regions in the context of lower incomes.

The first was a sharp increase in payments under the item *General Government Expenses* amounting for almost 40 percent – from 219.7 billion Rubles in 2009 to 307.2 billion in 2010. At the same time, the total expenses of regional budgets for the first post-crisis year decreased by 10.6 percent. The meaning of these figures becomes clear if we keep in mind that within the framework of this budget line, the lion's share of the expenditures goes under the item *Servicing of State and Municipal Debt*. In other words, the regions, to stay afloat, rushed to the federal Center for extraordinary financial assistance. Which is quite rational: in the absence of other sources of financing and economic growth, assistance can come only from Moscow, which thanks to the prudence of the Minister of Finance Kudrin really had accumulated a serious dollar airbag by then: this was economic unitarianism in action. The difference with the era of the collapse of the Soviet vertical is that Putin's version of unitarism is less ideological and more professional.

The second common feature of the economic behavior of the regions was a sharp increase in opaque budget items such as *Other National Issues* or *Reserve Funds*. The regional elites, having received additional financial injections from Moscow, sought to maximize the discretion in their utilization, beforehand transferring this sphere as closed for the population (and to a large extent even for the Center!).

At the same time, the planned regional expenditures fell by 33.3 percent under the *National Economy* item, 18.8 percent under the *Housing and Communal Services*, and 14 percent under the item *Inter-budgetary transfers* (usually this means helping municipal budgets from regional ones).

So, we can talk about the greatly increased dependence of regional budgets on the Center with a simultaneous desire of local elites to spend the funds as covertly as possible and save on investment, utilities and social obligations – in particular, on budget support for small and medium-sized cities. From here, *real*, not declarative priorities of the regional economic policy of the Putin's era are easily derived:

1. Limitation of the economic independence of the regions and their growing dependence on the Center.
2. The growing concealment of local budgets in the interests of regional elites.

3. Lack of interest among the regional elites in investment activity with shifting the burden to the most unrequited and politically weak link: the population and weak provincial towns.

Moscow news

A logical continuation of the process was the proposed appeal by Putin to the Federal Assembly on 15 January 2020 – the idea of destroying the guarantees of urban self-governments enshrined in the 1993 Yeltsin constitution and returning them to the Soviet vertical model when the Center (Central Committee of the CPSU) leads the regions (Regional Committees of the CPSU), then come cities (CPSU City Committees), and finally the District Committees. The Yeltsin reforms, reminiscent of a timid attempt to implement the principles of Magdeburg rights in Russia, were safely buried by Putin, first at the level of everyday political practice, and since 2020 already at the level of constitutional norm.

Those who follow the process are not surprised. In December 2011, the so-called Kozak-Khloponin decentralization commission presented to the then president Dmitry Medvedev a report on the transfer of more than one hundred powers from the federal to the regional level.[7] But in March 2012, Vladimir Putin became president, the illusory 'Medvedev thaw' ended and the commission along with its report was forgotten. On the contrary, in 2013 the share of the personal income tax remaining at the municipal level was reduced from a total of 20 percent to 15 percent for urban districts and to 10 percent for municipal districts. Since even before this, many medium-sized cities and regional centers – alphabetically from Angarsk to Rybinsk – were demoted to the status of *urban settlements* with corresponding cuts in their rights and budgets, the general trend is obvious. Grassroots initiative and responsibility are suppressed in order to strengthen the power of higher levels of the authority hierarchy.

It is not difficult to predict the medium-term consequences: increased borrowing by the regions, slowdown of local economic growth, and the accumulation of social and communal problems. But that ensures privileged access to resources (and, therefore, political loyalty!) for the most influential lobbying groups that redistribute funds coming from above. First of all, these are the largest business structures at the federal level with direct access to the Kremlin: oil, gas, pipeline, defense, and infrastructure companies. As well as a regional bureaucracy built into the unitary vertical, carrying out administrative control on the ground.

The structure of Putin's territorial management in a hybrid (intermediate) form replicates the vertical-branch ("sectoral") model of the Brezhnev era, of course, adapted to the demands of the time. But the underlying principle has not changed much: access to resources controlled by the Center in exchange for loyalty. An inevitable element of the model is corruption and income polarization between groups embedded in the vertical and the rest of the population. Both territorially and socially. Moscow is again tearing itself away from the rest of the country, the nomenclature estate from the rest of the population.

An important update, unlike the Stalin era, was a system of encouragement and motivation for members of the power corporation. Under Stalin, fear came first. With regard to the regions, this meant the obligation to tear out the established amount of tribute at any cost from your body and return to the Center the established amount of tribute – under mortal threat. Today, the system is much more humane and relies more on a positive incentive, which can be defined as corruption buying up loyalty.

However, as under Stalin, the model implies the suppression of local initiatives, discipline and unquestionable submission to the Center. However, now we are no longer talking about the total drainage of resources from the territories (the role of an income provider is reserved for a small number of oil and gas 'Klondikes'), but rather about a centralized distribution of benefits goods depending on the 'right' or 'wrong' behavior of local elites.

The paradoxical consequence of such a system of priorities is the irrational (from the point of view of European thinking) manner of behavior of the Russian regions. The poorest territories in the elections demonstrate the highest and cohesive support of President Putin and United Russia!

For analysis, we take 10 constituent entities of the Federation with the *minimum* values of the share of the 'middle class' in 2019 (the 11th row in the table is added as an unnecessary illustration of the trend). The 'middle class rating' was compiled by the information agency *RIA Rating* according to the official data of Rosstat and shows the proportion of families in the region who are able to purchase a car and apartment that correspond to the size of the family[8]. And let us compare them with the top ten regions that showed *the highest* electoral support for United Russia and President Putin in the 2016 and 2018 elections – according to official data of the Central Election Commission of the Russian Federation.

The percentage of support is calculated not from the number of voters who have voted, as usually, but from the *total payroll* of the regional electorate. With this approach, the final indicator also includes an assessment of the turnout (activity) of regional voters, that is, it reflects the ability of the regional leadership to ensure mobilization of the electorate – even if only virtually. The names of the regions that fall into all three lists are highlighted. There are seven of eleven of them, and all of them – amazingly! – turn out to be ethnic autonomous republics within the Russian Federation. Only a statistical accident prevented the Republic of Tuva from entering this list – in the ranking of the 'middle class' it took 14th place from the end (6.6 percent) and therefore did not get into the ten or 11 worst ones. But it is convincingly among the best in terms of the electoral support of the Kremlin: clans associated with defense minister Sergei Shoigu, an ethnic Tuvinian, exercise control here.

Table: Economic development and electoral mobilization of regions

	The share of the middle class, percent (Last 10 regions)	***Support for Putin-2018, percent of the list of voters*** (First 10 regions)	***Support for United Russia-2016, percent of the list of voters*** (First 10 regions)
1.	Ingushetia 1.9	Tuva 86.1	Chechnya 91.4
2.	Chechnya 2.5	Kabardino-Balkaria 85.6	Dagestan 78.3
3.	Dagestan 2.9	Chechnya 83.7	Karachay-Cherkessia 76.3
4.	Kabardino-Balkaria 4.1	Dagestan 79.4	Tuva 74.1
5.	Karachay-Cherkessia 4.4	Yamal-Nenets Autonomous Okrug 78.6	Mordovia 70.0
6.	Kalmykia 4.9	Karachay-Cherkessia 76.5	Kabardino-Balkaria 70.0
7.	Crimea 5.5	North Ossetia 73.3	Tatarstan 67.1
8.	Ivanovo region 5.6	Kemerovo region 71.0	Kemerovo region 67.1
9.	North Ossetia 5.8	Ingushetia 68.2	Ingushetia 59.0
10.	Orel region 6.1	Chukotka Autonomous Region 67.7	North Ossetia 57.4
11.	Mordovia 6.3	Mordovia 66.4	Yamal-Nenets Autonomous Okrug 49.9

Source: https://riarating.ru/infografika/20190813/630131892.html; http://www.izbirkom.ru/region/izbirkom. Electoral support in terms of the list of voters was carried out by the author based on data from the Central Election Commission of the Russian Federation

Almost all the regions that are on the list are among the so-called 'electoral sultanates', known for rough and outright falsification of results. The official election results here reflect not so much the mood of voters as the desire of regional elites to curry favor with the Moscow leadership.

It is worth noting that the most advanced, urbanized and Europeanized regions, where the socio-cultural environment shows great resistance to electoral fraud, on the contrary, have the highest middle class share. And, accordingly, a reduced willingness to support Putin and his party. So, in the 2016 State Duma elections, United Russia (again in terms of the list of voters) in St. Petersburg received only 13 percent, and in Moscow and the Novosibirsk region – 13.3 percent. 7 times less than in Chechnya and 6 times less than in Dagestan.

A conclusion can be suggested here, which confuses many democratically minded opponents of Putin. In the context of *real* post-Soviet Russia (and not that fictitious Russia as visioned by capital city's fighters for civil liberties!), in order to maintain political control, the Kremlin does not have to worry about a serious elevation of citizens' standard of living. On the contrary, in some cases this is directly harmful to it: the richer, more educated and more independent the masses of voters, the more difficult it is for leadership to manipulate them and receive electoral support.

The opposite is true regardingAnother thing is the standard of living and satisfaction level of regional, law enforcement, media and administrative elites! They just have to feel completely satisfied. It is no coincidence that with the negligibly small tax revenues in the Chechen Republic, the per capita income of its budget due to Kremlin transfers is 15 percent higher than the national average. True, this is only a calculated figure obtained by dividing the allocated budget amounts by the number of the local inhabitants. How much of this money actually reaches the citizens, and how much it gets stuck in the hands of the local nobility, can be judged by the 'middle class' rating presented above – Chechnya has the last but one place among 85 regions. The last place is held by neighboring Ingushetia, also known for the incredibly united electoral support of the Moscow leadership. It is not difficult to see behind this a rollback to the instinctive priority of the territorial management of the Brezhnev era: "*let the regions be better poor, but obedient (and live off transfers from the Kremlin) than rich, but uncontrolled*."

Since the second half of the 2000s, regional differences in gross regional product (GRP) per capita have been somewhat reduced due to the redistribution of oil and gas excess revenues to lagging territories through budget transfers. This in itself is normal. The question is only to the extent. Today it is already clear that the Center too slowed down the growth of advanced subjects of the Federation for the sake of supporting and preserving the weak economic policy of the lagging territories. The periphery has strengthened in its backwardness, having received illusory relief not due to its own achievements, but thanks to the 'pay for loyalty'. The result was a twofold decrease in the number of 'donor regions' (federation entities that do not receive federal subsidies for 'budget equalization'). Even in the 'dashing 90s' in the country there were 20–25 regional 'donors'; now there are just 12–13 of them left.

The boundaries of the possible

During the market reforms in the cities (primarily the largest ones, led by Moscow and St. Petersburg), their status have noticeably increased – which was accompanied by an increase in separation from country's general socio-economic fabric. This was inevitable – not only the natural agglomeration effect worked out in favor of the cities (concentration of qualified personnel, post-industrial initiatives and innovations, a relatively favorable legal environment), but also the materialized inertia of the Soviet era. As a result, only 3 of 85 subjects of the Federation (Moscow and two oil and gas regions of Western Siberia – Yamalo-Nenets and Khanty-Mansi Autonomous Districts) provide 55 percent of the revenues of territorial taxes to the Federal budget. If you add Petersburg to them, the contribution of these four will be 60 percent.

At the same time, incoming taxes were divided between the Center and the regions in a proportion of about 50 : 50 during the Yeltsin era, but under Putin, the ratio changed to 60 : 40, or even 62 : 38[9]. Not in favor of territories, of cource. More precisely, if we connect the municipal level to this conditional calculation, the proportion of the distribution of budget revenues in the triad of Center – regions – municipalities looks more like 60 : 35 : 5, while defenders of budget federalism consider the formula 30 : 40 : 30 to be fair[10].

The Kremlin is trying to compensate for the imbalance through so-called '*national projects*'. They, like the Soviet '*industry programs*' are developed in Moscow and funded from Moscow. Perhaps, a different way is no longer possible, because dozens of constituent entities of the Federation and hundreds of cities have such a low level of economic development, human resources, transport and social infrastructure (respectively, the tax base) that they have no chance to get out of structural poverty on their own. Rather, there is a chance to disappear from the face of the earth as in the Soviet era 'unpromising settlements' disappeared. It also makes no sense to feed these failed territories with treasury investments – the funds will be spent 'inappropriately' – that is, eaten or stolen. It remains to keep them afloat with subsidies and hope to get on the list any of the '*target programs*' that will bring funding, management, design and personnel from the Center. The problem of regional poverty and hyper-centralism in Russia has acquired a chronic self-reproducing character, stretching over several generations.

In fact, the ideology of centralized '*national projects*' grows in an implicit form from the Stalinist perception of the territory of Russia as a kind of phenomenological 'void', which must be filled, structured, colonized and mobilized by the life-giving will and energy of the Leader and the Center. The difference is that before the Bolsheviks and in the first years of their rule, the socio-economic space in fact (contrary to Soviet propaganda!) was still full of life – in terms of infrastructural, economic, demographic potential – down to the cultural background, including work ethics. The Bolsheviks had what and whom to mobilize, inspire and guide. But after them there remained a devastated land with an underdeveloped road network, broken demographic growth, a 'wooden' non-convertible Rubles and a management structure that is centralized to the point of absurdity. To paraphrase the famous apocrypha about the A-bomb, we can say that Stalin inherited the country with two competing capital cities of the European level (St. Petersburg was much stronger than Moscow in all key respects), but left it in possession of one. Moreover, the one pushed far back eastwards from the 'window to Europe'.

There is nothing left to squeeze out of the devastated socio-cultural space. Of course, except oil, gas and some other natural resources. The Center is forced to carry out the exact opposite task – not to squeeze resources out of the country for the sake of militarization, mobilization and territorial expansion – but, on the contrary, to pump funds into its own territories so that they do not suffocate or fall off. It turns out badly: it's like a giant vacuum cleaner built and fixed by generations of Soviet engineers to exhaust resources from the country, which now is used to solve the opposite task of allocating resources to regions. There is a lot of dust and noise, but the material result is not impressive.

The idea to revive Russia's territories through 'national projects' invented at the Center or inspirational decrees (in particular, the widely known Putin decrees of May 2012) works just as poorly as did "historical decisions of the CPSU congresses" – because they stem from quite similar priorities. The national project *Demography*, updated in May 2019 and put on the first place in January 2020 by President Putin's address to the Federal Assembly, is not feasible in the same way as promises to build communism or party's appeals to introduce advanced achievements of science and technology into socialist industry.

In only January–October 2019 the population of the Russian Federation decreased by 260 thousand.[11] the version of May 2019 of this *national project* requires a reduction in the rate of population decline in 2020 to 127.4 thousand, i.e. about twice. In 2024, it is planned to stop the fall and move on to growth. Against this optimistic background, Rosstat presented in December 2019 the basic scenario of the demographic forecast, where by 2027 a twofold acceleration of the natural population decline is set to 583.5 thousand people per year. The scenario assumes a decrease in the population of the Russian Federation from 146.7 million in 2019 to 143 million in 2036. This is 1 million worse than the same Rosstat foresaw in October! the tasks set by the government are obviously unrealistic – and this follows from the figures proposed by government forecasters. Absurdity?

In 1900, about 75 million people lived in Tsarist Russia (in terms of its modern borders). In the United States, at the same time, the population was 76 million. In 2019, it became 147 million in Russia (roughly speaking, a twofold increase in 120 years), and in the United States 329 million – an increase of more than 4 times. Moreover, the rates of urbanization and the associated 'demographic transition' in the reproductive behavior of Americans are higher and were achieved much earlier than in Russia... No other country in the world had such a catastrophic twentieth century as Russia. It is already impossible to get out of the negative demographic trend that was laid back in the Stalin era. The same can be said about territorial development.

The super-centralized model constructed by the Bolsheviks for ideological reasons (concentration of resources to carry out the struggle for the World Revolution, for militarization and expansion) today has turned into a *material* factor in the organization of the socio-cultural and economic environment: the distribution of cities and population, the geography of transport infrastructure, etc. The rejection of centralization is fraught with degradation and backsliding territories. Maintaining centralization is fraught with stagnation, the accumulation of regional problems and a loss in international competition. What remains to Kremlin is to maneuver in a narrowing corridor of opportunity, masking failure with propaganda and falsification of economic and electoral statistics. The familiar Soviet way – although, again, in a softened and hybrid form.

In terms of gross domestic product per capita by purchasing power parity (data from the International Monetary Fund, 2018), Russia ranks 49th in the world ($ 29.3 thousand), behind Lithuania (38th place, $ 34.6 thousand), Estonia (39th place, $ 34.2 thousand) and Latvia (47th place, $ 29.9 thousand)[12]. The task of catching up with Portugal in terms of per capita GDP, with which Putin came to power 20 years ago, has not been fulfilled: in 2018, Portugal ranks 42nd with per capita GDP of $ 32.0 thousand.

Even more striking manifestations of stagnation become visible when looking at the internal structure of the state. Having the same level of education, and taking the same position, you can be relatively wealthy in one region, and very poor in the other. The average per capita income in Moscow in the 3rd quarter of 2019 is 74,341 Rubles (more than 1,000 Euros), but in the Republic of Tyva – 14,776 rubles (about 210 Euros). 30 percent live below the official poverty line in Ingushetia, 24 percent in Kabardino-Balkaria and the Altai Republic, and less than 7 percent in Moscow, St. Petersburg and Kazan[13].

Demands of territories are growing, and the Center's ability to satisfy them is declining. Most regions did not manage to form independent sources of growth. Since 2015, the periphery (where it is not under the control of electoral falsifiers) has been showing growing irritation, which manifested in the federal (2016) and regional (2018) elections. Especially painful figures are shown by the lands of Eastern Siberia and the Far East – despite the fact that there are all conditions for economic growth based on self-reliance.

Unfortunately, the growth did not take place; years of favorable oil and gas prices and investment conditions have been wasted. The outflow of qualified population to the relatively prosperous large-urban regions of the country's European part is growing, primarily to Moscow. There is a kind of 'reverse frontier.' the descendants of those who two or three (sometimes four to five, if we keep in mind Stolypin migrants) generations ago moved to the East to develop new lands, today, clenching their teeth, make their way back to Moscow and St. Petersburg. And often straight to Berlin, London or, New York.

Strengthening the economic and political role of the Center is conceived in the Kremlin: (a) as a defense against separatism and (b) as a basis for strengthening the armed forces. Which, in turn, serves as the basis for 'raising from the knees', aggressive propaganda and attempts to regain the lost geopolitical influence. The idea that the collapse of the USSR was a delayed consequence of just such Stalin-Brezhnev priorities is deeply alien to these strategists.

At the same time, they have learned for themselves a number of concrete lessons from the collapse of the USSR and the gravest mistakes of the late Brezhnev and Gorbachev era, trying not to repeat them. The Putin's vertical is more flexible and more rational than the Soviet one. It may well hold out for a few more years – apocalyptic forecasts of the imminent fall of the regime represent a wishful thinking. Therefore, there is no reason for optimism.

By the beginning of the third decade of the XXI century the innate disease of the Soviet system of priorities manifests itself with renewed vigor. The principle of integrated development of territories once again predictably lost to the principle of strengthening the omnipotence of the Center. This, although at a new level, predetermines understandable problems for the coming years, as well as the expected attempts to resolve them with the help of 'manual control'. Personnel leapfrogging of the regional leadership, attempts to appeal to strengthen discipline, protectionism, tough methods of suppressing protests emerging in the local areas, increased propaganda and censorship in the hope of switching public opinion from economic problems to searching for external and internal enemies.

Conclusion: Medium term prospects

Frightened by the territorial split of the Soviet Union and dependent on Soviet geopolitical instincts, 'collective Putin' is doomed to resist the ideas of decentralization and federalization. He will fight to strengthen the Center, perhaps even more desperately than his Soviet predecessors. Therefore, the general features of the regional policy for the coming years are not so difficult to predict. As well as related problems.

This is the dominance of centralization, freezing of status quo and militarization amid a painful rejection of any attempts to optimize territorial management and delegate authority downwards, which in itself deprives the system of flexibility and increases the risk of a subsequent split against the background of the next attempt to catch up with development. Putin's Russia has returned to the Soviet path dependence and is unlikely to get out of it until the next major crisis. The process will go on against the background of a steady general depopulation and with an increasing outflow of the population to a few growth areas – mainly to the largest cities. Or straight abroad.

The polarization of the social and geographical space and the deepening of the abyss between growing million cities and the stagnating second/third-rate territories will continue. In 2019, the Russian Federation had 15 cities with a population of over one million people – from Moscow with 12.6 million people to Volgograd with 1.0 million[14]. For comparison: the United States with a twice as large total population and half as large territory, has only 10 million cities – from New York (8.4 million) to San Jose (1.0 million). But there are 304 cities with a population between 100 thousand and one million. There are only 156 such cities In Russia and there is no reason to hope for an increase in their number. The normal hierarchy of the population distribution system has been eroded.

Advanced large-urban areas will grow in much the same way as their counterparts around the world do – fortunately, they have enough of their own resources in addition to the distribution policy of the Kremlin. Legalistic, moderate opposition sentiments will also draw in there, since the conservative line of 'collective Putin' contradicts the interests of super-cities. At the opposite pole of the political space, geographical and social periphery will expand (based on federal subsidies). Today, due to the falsifications and complete economic dependence of the 'electoral sultanates' on the Center, it serves as the political pillar of the Kremlin – but in the event of economic or social difficulties, it can break out in fire of the most radical and anti-legalist protests.

But the most destructive, long and seemingly inconspicuous process will develop in 'central Russia' somewhere between super-cities and the national super-periphery. The result will be the desolation and abandonment of 'medium' cities and territories between areas of super-urban growth. Against the background of the huge size of the country and the ongoing concentration/outflow of the population, this threatens with the loss of economic and social cohesion of the nation.

In the 'middle cities' and the stagnating province, which have neither resources nor hopes to receive them, social, environmental and utilities (water supply, heating, waste processing) problems will accumulate. As a result, there may be a local outbreak of aggression along the lines of 'garbage protests' that suddenly appeared at the federal level. Motivation to work erodes. The deviant behavior and uninhabited 'dead zones' are expanding. Stagnation and lagging behind the requirements of the time for the infrastructure skeleton – transportation – is above all. This will greatly complicate the increasingly urgent task of re-developing abandoned and feral lands – even if someone would deal with it in the future. Although who would?!

As a result of polarization, there are ethnic and religious conflicts between people who come from very poor national entities that are continuing their demographic growth (republics, autonomous regions) and developed territories that host these people. Instead of the mythical threat of a colored revolution, there is a more dangerous, but still unrealized (invisible from Moscow) threat of sliding to the living standards of the Third World – for a significant part of Russia's 'middle territories'. Instead of being burnt in the romantic fire of the revolution, the nation can drown in the by-products of its own vital activity.

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Military Expenditure During Putin's Rule

Aleksandr Golts

Russia consistently ranks at the top of the list of countries with the highest military spending. Although military spending is only the second largest item in the budget and is inferior to the total expenditure on social needs, Russia's spending on education and medical care is on average twice as inferior to similar expenditures of developed countries. In Russia, poverty persists, humiliating a country that considers itself a "great power". But at the same time the military spending corresponds to that of the most developed countries. It's no doubt that this approach will remain for all the years Vladimir Putin is in power.

Spending on defense, security and law enforcement are main items of the Russian Federation budget. All twenty years, when Vladimir Putin headed the country, these expenditures steadily grew by 10–15 percent annually. In 2006–2011, spending on defense, security and law enforcement averaged exactly 25% of budget spending. In 2012–2017 they already reached 30.7% of all federal spending. Spending on defense, national security and law enforcement peaked in 2016. It reached 5.674 trillion rubles (defense spending was 3. 895 trillion). This accounted for 34.6% of all federal budget expenditures. In 2018, military spending fell significantly – to 2.827 trillion[1].

Approximately the same defense budget should remain in 2019–2021. According to Anatoly Popov, Director of Finance Ministry Department for budget policy in the sphere of the state military and law enforcement services and the state defense orders, during this period "together with the secret part, the expenses for law enforcement, defense and security make up 30% of the state budget expenditure"[2]. The funds allocated to the Russian Defense Ministry in 2020 will amount up to 1.894 trillion rubles, while in 2021 the expenditures of the military Department will be reduced to almost 1.574 trillion and will increase slightly to 1.609 trillion rubles in 2022. The main part of the expenses of the Russian MOD will be directed to ensuring national defense. In 2020, 1.056 trillion rubles will be spent for this purpose. At the same time, this item of expenditure will grow – to 1.077 trillion in 2021 and to 1.096 trillion in 2022. Basically, the amount will be increased by spending on the Armed forces of the Russian Federation, included in the section "National defense". Next year, 973 million rubles will be spent on them, a year later – 995 billion rubles, in 2022 this amount will grow to 1.024 trillion rubles[3].

At the same time, the announced figures cannot be considered final. In accordance with the established practice, the 2018 Federal budget implementation was accompanied by two adjustments – in July and in November. The allocations for the "national defense" section established initially by the law on the Federal budget for 2018 were increased by 28 billion rubles to 2.797 trillion rubles in July and by 31 billion rubles (by 1.1%) to 2 trillion 828 billion rubles (2.7% of GDP) in November. It is safe to assume that this practice will continue.

Secrecy rejects the control

Russian leaders use two arguments to explain their apparent preference for military spending. First, they claim that Russia is in a hostile environment, that a new military confrontation with the West and an arms race have been imposed on it. Therefore, increasing military spending is the only way to ensure the security of the country. The second argument is that investments in the weapons production have a multiplier effect and turn into economic growth. Deputy Defense Minister Tatyana Shevtsova considers the investment of the military budget the main driving force of the economy: "the Defense budget is a factor of stability and further development of the domestic industry, which, thanks to firm orders from the Defense Ministry in the coming decades will be able to update the technological base and create a significant number of new skilled jobs ... companies, one way or another involved in the production of military products, of which 1339 enterprises included in the unified register of the defense industry, form the basis of domestic industry, about 1 thousand – work with them in cooperation, the rest supply materials and components."[4]

Defense Minister Sergei Shoigu prefers to laugh it off when asked if Russian military spending is excessive.[5] Let's, he says, not reduce costs, but increase revenues. However, the problem is not only in the size of the military budget, but in how spending is justified. There is no civilian control over military spending (as, indeed, over all defense and law enforcement activities) in Russia. The society knows almost nothing about the effectiveness of these costs.

It is obvious that in recent years the Russian Army has become much more effective. It has gained the ability for rapid deployment, as demonstrated during the Crimea annexation, the "secret war" in Donbas and the operation in Syria. In addition, during the implementation of the 2011–2020 Rearmament Program, for the first time in the history of modern Russia, it became possible to establish the production of if not state-of-the-art, then at least new weapons. According to official data, by the end of 2019, they will amount to 68.2 percent of the total volume of all armament[6]. Of course, sustainable and abundant funding has played an important role.

However, it is impossible to draw objective conclusions how effectively these huge funds are spent. The reason is the paranoid desire of the Russian authorities for secrecy. According to the budget classifier, the government presents in the open part of the budget (the secret part should be known only to the members of the Duma and the Federation Council defense committees– it is not known how much information about the military budget is available even to them) only a dozen sketchy figures. These figures exist in the budget under titles "National defense", "Armed forces of the Russian Federation", "Mobilization and non-military training", "Mobilization preparation of economy", "Nuclear weapons complex", "Implementation of international obligations in the sphere of military technical cooperation", "Applied scientific research in the field of national defense", "Other issues in the area of national defense." Direct and indirect military expenditures can be also found in other sections – from "Main national issues" and "National economy" to "Physical culture" and "Culture and cinematography". According to Vasily Zatsepin, these expenditures in 2018 amounted to 1.4 trillion, that is, about half of all defense spending[7].

The so-called "open" budget items provide very little information. In fact, the public is provided with a few meaningless figures every year that can neither be verified nor evaluated. Well, what's the use of the fact that public was told that the Armed forces next year will spend 2,138 trillion rubles, and the "security agencies" (even without detailing the departments) will get 300 billion? Analysts who do not have "access" to classified materials can only state whether the total costs of a particular item increase or decrease compared to previous years. It is almost impossible to know from these figures how the huge funds will be spent. The Russian Parliament has abandoned the function of civilian control over military spending. The activity of parliamentarians is limited to periodic demarches to the government with the requirement to increase a particular item of military spending. For instance, criticism of the military budget of 2020 was concentrated on the fact that the State Duma Committee on defense disagreed while discussing the budget with insufficient expenditures on pensions for military veterans, financing of military mortgages and purchases of fuel and lubricants[8]. At the same time, the parliamentarians did not even try to revise the structure of military spending, redistribute funds.

Having made secret all meaningful financial information in the field of defense and security, the Kremlin paradoxically began to lose control over how finances are spent. Freed from any control except departmental, officials began to lie outright. Sometimes the Kremlin and the Defense Ministry get into frankly stupid situations. Traditionally, the results of the Defense Ministry activities are summed up annually during the MOD board session. Each year the Defense Ministry head reports on the achieved successes do not coincide with the plans that were voiced a year ago. At the end of 2018, Defense Minister Sergei Shoigu reported on the implementation and even over-fulfillment of the defense orders. However, if one opens the speech of the MOD head at the end of 2017 at the similar board session, and the picture changes dramatically. According to the plans, in 2018, the troops were to receive 203 aircraft and helicopters, but they received only 126. Strategic Air Force received not six, as planned, but five strategic bombers. The Navy was supposed to get 35 ships and support vessels, but it had received only 25. It was planned to receive the strategic submarine "Knyaz Vladimir", then its delivery was postponed to 2019. It turns out that the defense orders for the most important items were fulfilled at best by 70 percent[9]. In 2017, the data on military spending that Russia reported to the UN was 1.7 trillion rubles less than those indicated in the state budget.[10] At the same time, no one is ashamed of the fact that the figures announced by the military Department do not fit together.

In these conditions, control can be carried out only at the departmental level. That is why once every six months, Vladimir Putin arranges multi-day meetings with the heads of the Armed Forces and the Military-industrial complex. Only in this way, he manages to compare the data coming from different agencies, each of which corrects them in their own interests, and then deliberately distorts for propaganda purposes.

Corruption – natural feature of military budget

It is secrecy that is the basis for the corruption that reigns in the execution of the state defense order. The authorities are trying to curb it, creating numerous supervisory agencies designed to monitor each other's activities. In the summer of 2015, a special law was adopted, which obliged companies to store budget funds exclusively in banks determined by the government. At the same time, the funds that financed the execution of the state defense order had to be "painted" in a special way, which would prevent their theft and misuse. After all, according to Deputy Defense Minister Tatyana Shevtsova, "there was a situation when we sent advances to the main contractors (of a particular project – A. G.), and they did not pass them on through cooperation (chain of suppliers – A. G.) They put money on deposit, issued a loan, but did not send them to the enterprises that cooperate ... The funds provided for the production of weapons could remain in the accounts of the company for six months, while the company and the suppliers were waiting for these advance payments to produce products."[11] It is clear that the money did not just lie on deposits, most likely, with the consent of top managers of the defense industry, these funds were scrolled. However, the new system did not stop the theft. It is no coincidence that two years later, Vladimir Putin toughened criminal penalties for crimes in the implementation of the defense order[12].

In the end, the government decided to concentrate all the funds of the defense order in one bank – Promsvyazbank. Its activities will be completely classified under the pretext of protection from Western sanctions. "Monopolization of banking services carries risks for defense industry enterprises of increase of improper expenses as it deprives main contractors of possibility to use at their choice a competitive authorized bank."[13], – Vladimir Gutenev, the head of the Duma Commission on legal support of the development of military-industrial complex organizations of the Russian Federation stated.

According to the Chief military Prosecutor's office, the damage from military corruption crimes for 2018 exceeded 7 billion rubles, while more than 2,800 officials were brought to disciplinary responsibility under the acts of the Prosecutor's office, and 28 of them were dismissed due to loss of trust[14]. In 2018 criminal cases in connection with corruption were opened against officials in the Department of contract audit of the Defense Ministry, the Military Academy of the General staff and the 46th MOD Central research Institute. All cases were united by overstating the value of contracts.[15] In particular, it was claimed that the space industry and the defense industry companies (including Rostech, Almaz-Antey, UAC and others) detected thefts of more than 1.6 billion rubles intended for the modernization of the production base and the latest advanced weapons development[16]. For example, an unnamed enterprise in the Vladimir Region supplied products for the needs of the Ministry of defense at a price of 332 thousand rubles per unit when their real cost was 9 to 11 thousand rubles. That is, the price was 30 times inflated[17]. Among other examples – the activities of "Stankoprom" industrial holding. None of the three projects for the serial production of machines, for the implementation of which in 2015–2016 the budget allocated more than 1.8 billion rubles, was completed and not a single machine was produced[18].

According to reports of state news agencies, the Prosecutor General was going to introduce legislative initiatives, the implementation of which would allow fighting corruption in the defense industry with new instruments. In particular, the Prosecutor General offered to give the preliminary investigators the right to initiate criminal procedures against crimes committed in the sphere of the state defense order, without naming the injured party. It was also proposed to oblige the military representations of the Ministry of Defense to verify the accuracy of the actual cost of the companies that violated the conditions of implementation of the state defense order.

The essence of these initiatives is obvious. Corruption in the defense industry is characterized by collusion between the supplier and the customer, which is a particular department of the Defense Ministry. Therefore, the MOD department is not eager to declare itself the injured party and inform the law enforcers about the violations. Similarly, it is highly unlikely that representatives of the military acceptance may not be aware of the repeated overestimation of the product prices. With the state imposing increasingly brutal measures, Putin is forced to admit impotence in the face of pervasive corruption. It has been said a hundred times: "Work in a transparent way; this is a huge, nation-wide project that involves huge funds." But no, they steal hundreds of millions. Hundreds of millions. Several dozens of criminal cases have been opened, investigations conducted, and people are in jail. But it still has been impossible to bring that place to order"[19] he stated, describing the situation with constructing Vostochny Space Launch Centre.

The inefficiency of the defense industry

Corruption is not the only problem of the military industry. The Russian military industry produces mainly repeatedly modernized weapons developed in the USSR 40 or 50 years ago. This is the main battle tank – T-72B3, Su-34 and Su-35 combat aircrafts, which are clones of the Soviet Su-27 fighter, most of the artillery systems. And widely advertised military projects – such as the Armata tank (T-14), do not go into mass production because of the weakness of the domestic military industry. So initially there was a state order for the production of 2300 copies of the T-14 until 2020.[20] Later it was 15 times reduced – to 132 combat vehicles.[21] If the decision on mass production is still taken, then it is a voluntary approach, when the real circumstances are simply not taken into account. According to the Rearmament program, it was supposed to produce 16 Su-57 fighters of the 5th generation in 2020–2027 (which meant the actual rejection of serial production). And suddenly Vladimir Putin made a sensation, saying: "the involved companies reduced the cost of the aircraft and arms by almost 20 percent, and we received an opportunity to buy many more combat systems of this class, virtually all of them are of the new generation. We agreed that we would purchase 76 aircraft of this type without an increase in costs during the same period."[22] One can only guess how reducing the cost of each aircraft by 20 percent can increase the number of aircraft purchased almost five times! After all, nothing was said about increasing the total funding of the Rearmament program.

The inefficiency of the defense industry is primarily due to its organization. In 2001–2010, all defense manufacturers were assembled into a dozen vertically built state corporations – the United aircraft Corporation, the United shipbuilding Corporation, Rostekh, Tactical missile weapons Corporation and others. In fact all this system is a caricature of the famous "nine" – nine Soviet military-industrial ministries. In these corporations there is a huge bureaucratic superstructure, and each relatively efficient company is doomed to sponsor several companies close to bankruptcy.

At the same time, manufacturers of specific types of weapons and military equipment are monopolists (such situation did not exist even in the USSR). Naturally, in this situation, the manufacturer makes the price unthinkably high. It includes all inefficient spending, the need to maintain both bankrupt enterprises and the bureaucratic vertical. As a result, one Armata tank costs more than 250 million rubles, approaching the cost of a combat aircraft. And the price of each Su-57 is more than 100 million dollars.

Another reason for the failures is the inability to establish production cooperation in principle. In the USSR, only the final assembly plants belonged to the defense industry. And components (in Su-27 there were 1500 such parts) were produced by the civil companies. It had nothing to do with reasonable economics. After all, in order to produce a limited number of components the manufacturer had to keep (and pay for) additional production capacity and labor force. The cost of this was included in the cost of civilian products. It raised the cost and reduced the quality of civil goods. It is no coincidence that USSR had to establish Gosplan (a body that held a very high position in the Soviet decision-making hierarchy) that was required to balance the prices of civilian and military products artificially. With the advent of the market economy, the defense order with its relatively small production volumes, dependence on military officials, senseless secrecy measures, which only complicated civilian production, became unprofitable. Complex chains of industrial cooperation crumbled.

Eventually, the richest military-industrial corporations began to build additional facilities for the components production. The way it was done, the air-defense corporation "Almaz-Antey", built two new plants. And those who do not have such opportunities, produce components in a semi-amateurish way at the final assembly plants. That does not allow running large series and makes the products themselves as costly as if they were made of gold. So comes KnAPO-Komsomolsk-on-Amur aviation plant, the main manufacturer of the Su-35 and Su-57. If clones of the Soviet fighter or the tank still can be produced somehow, then serial production of new weapons with fundamentally new components, as we see on the example of "Armata", is not possible to organize.

The low efficiency of the domestic defense industry is evidenced by the poor financial condition of the companies. The military industry companies have about two trillion rubles debts, said supervising "defense" Deputy Prime Minister Yuri Borisov, admitting that companies are unable to pay off these loans.[23] This makes the defense industry the fourth most indebted (after financial services, wholesale trade, real estate transactions) sector of the economy. The credit bubble in the military industry is especially dangerous, since these trillions were distributed only by a few authorized government banks, and now will be concentrated in "Promsvyazbank".

The main trouble is not even in the size of loans, but in the fact that about a third of the total debt is not repaid, they only serve interest. According to Borisov, defense enterprises spend about 200 billion rubles each year to pay interest. At the same time, "the main body of the loan will never be repaid", the Deputy Prime Minister believes[24]. Earlier, he compared the work of the military industry with an attempt to move on an exercise bike: no matter how much pressure on the pedals is exerted, you still will not come anywhere. The main client of the defense industry – the Russian Ministry of Defense – does not observe any problems with manufacturers.

The way out of the situation Borisov suggests is simple: the state should simply write off the debts of defense companies in the amount of 600–700 billion, so that they do not live "starving"[25]. Thus, Russian citizens, whose taxes directly or indirectly (through taxes of state-owned companies) form the state budget, will have to pay twice – first in the form of funds released under the state defense order, and then – when writing off the debts of the defense industry – to finance military production. In 2016, the Ministry of Finance has already allocated 800 billion rubles for early repayment of loans issued to defense companies, in 2017 – another 200 billion[26]. In the interpretation of the officials the military industry over-indebtedness is a kind of natural disaster. No one even tries to explain how it turned out that with seemingly regular and full funding military enterprises cannot repay loans from their profits.

Yuri Borisov wisely did not name the reasons for these difficulties. According to him, in 2010–2011, it is unclear why "the rate of attracted loans was 10, 11, 12 percent". At the same time, it is well known that these years the unprecedented 23 trillion rubles state arms program was launched. On the one hand, the Russian authorities could not afford to disrupt this program, as all the previous ones. After all, this time the rearmament was to be the most important element of military reform. But on the other hand, at this very moment the state, which was struggling to get out of the 2008 economic crisis, did not have the means to invest four dozen extremely expensive projects at once. In this situation, then-Prime Minister Vladimir Putin made a decision that even the most cautious economic experts call "exotic". Either on his own initiative, or at the suggestion of the heads of authorized state banks (who decided to take advantage of the moment and provide themselves with a huge income for decades to come), the Prime Minister decided that the state program will be financed by these banks under state guarantees. Banks set extortionate interest rates.

However, if it came down only to prohibitive interest for profitable production, the problem would be solved by payments in 2016–2017. Meanwhile, the situation, as we see, is regularly repeated. Obviously, the reason is not only in the desire of the state banks to get high interest rates. Probably, it is the low efficiency of production, and, as a consequence, the increasing cost of specific weapons systems.

This was acknowledged by Vladimir Putin during the meeting of the Military-industrial Commission: "shortage of capital is the result of many things including under-utilized capacity due to reductions in orders and the costs of financing R&D; research expenses were not accounted for in the planning documents"[27].

But if the current military production is inefficient and unprofitable, maybe the officials are right, claiming that it can be the engine of economic development of the country. One of the main economic ideas that Vladimir Putin periodically expresses is that the potential of the Russian military-industrial complex can be used for the production of civilian products. The President states that the peak of the rearmament program has passed, and production facilities should be kept to maintain "mobilization readiness": "I want to say that the economic ability to increase the production of defense products and services quickly is a vital element of military security. All strategic and simply large companies, regardless of the type of ownership, must be able to do this... Instructions were issued to modernise production, to create a reserve of material and technical resources".[28] the President has already outlined plans for conversion – however, this term itself has never been mentioned, in order not to remind of the infamously failed previous attempts (first under Gorbachev, then – under Yeltsin) to transfer military industry to civilian production. Putin demands that share of high-tech civilian and dual-purpose goods in defense companies' output must increase to 17 percent by 2020, 30 percent by 2025 and 50 percent by 2030[29]. The most curious thing is with what measures Putin intends to achieve the result.

First, the President ordered to develop "legislation that will determine the range and the share of civilian products to be purchased by natural monopolies, state corporations and federal government bodies. As we agreed, they should become the key purchasers of such products at the initial stage"[30]. In addition, he ordered to draw up a clear program of "diversification" of production, "to represent how much and what civilian products will be produced by each defense company and to what markets it plans to deliver"[31]. Putin did not forget about the need of a financial support for the program.

In fact, this system has to fix on legislative level how much civilian products a particular state-owned company should produce, and then, relying on the same laws, force another state-owned company to buy these products. In essence, it is a return to the planned economy in one of the most important sectors of industrial production. Logically next step will be to revive Gosplan – the body which will artificially "assign" prices for goods and subsidize the purchase of raw materials. Naturally, such industrial organization should exclude any competition, especially from foreign manufacturers. Consequently, the military industry is doomed to carry out the conversion in the conditions of strict autarky.

It is not so difficult to predict what will happen if these plans are implemented. The process of "internal" consumption of resources and finances, when neither productivity nor quality increases, will be included. The money will be paid for products that no one needs. When the consumer cannot refuse buying the product, no technological breakthroughs, of course, can happen. The manufacturer is not interested in the use of more advanced technologies. After all, the buyer has no chance to refuse the purchase. And the quality and compliance with international standards are evaluated by the departmental commission. This is a direct way to repeat the crisis of overproduction in the sphere of military production, which once finished off the Soviet economy in 1980s.

It is important to note that in all the other world, the main breakthrough technologies have long been born not in military laboratories. In the face of the scientific and technological revolution, the pre-paid demand for high-tech in the civilian sector – smartphones, video equipment, increasingly sophisticated computers and electric vehicles – far exceeds any conceivable state investment in military technology. It is due to demand that the largest Western corporations finance military developments today. State investment began to play a secondary role. Technology is now coming not from the military sector to civilian, but vice versa.

Conclusion

As a result of the military reform, the Armed forces received quite modern organizational models. However, in the sphere of financing the army and organizing the military industry, the Kremlin prefers long-outdated schemes. Russia spends disproportionately large amounts of money on military purposes. They are spent without any public control. As a result, these expenditures are inefficient. Their essential part is stolen. This money is lost due to inefficient organization of the defense industry. However, strengthening military power is an absolute priority for Vladimir Putin. It is safe to assume that in the future Russia will spend more and more of its national wealth on military purposes. At the same time, less and less money will be spent on purposes indirectly related to military power: health and education, fundamental science. Thus, excessive military spending by Russia can only bring a short-term effect.

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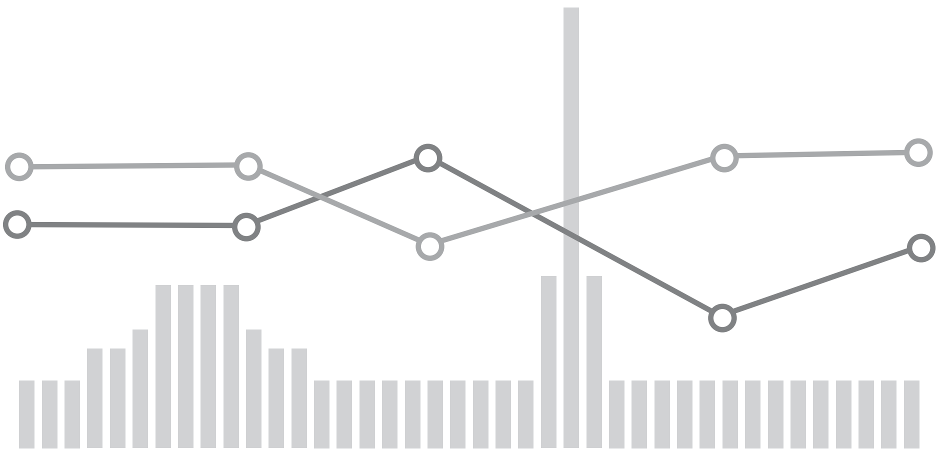
Part II: International Dimension



Russia and the European Union – The Changing Role of Energy

Kai-Olaf Lang, Kirsten Westphal

Energy and trade exchange have always been key elements in the relations between the Russian Federation and the European Union. Irrespective of all political uncertainties and setbacks, economic cooperation and, in particular, energy relations seemed to be something like the hard core of mutual interaction.

Thus, it comes as no surprise that relations in the field of energy have usually formed a highly important component of the various concepts that both sides have regarded as frameworks for cooperation – from the Partnership and Cooperation Agreement over the Four Common Spaces to the Partnership for Modernization.

However, especially after the EU enlargements of 2004 and 2007, when many countries with a difficult past regarding Russia and the Soviet Union had joined the community, the differences within the EU arose considerably: Whereas some member states continued to regard cooperation with Russia in the field of energy as something like a glue, which stabilizes EU-Russia relations, or even as a locomotive of collaboration, which will create positive spill-overs into other areas, a substantial number of member states holds energy cooperation with Russia to be a source of dependency and a security risk.

Irrespective of these discrepancies within the EU, both sides, the EU and Russia are considerably varying in their approach to energy policies. The EU is not only an energy consumer and a customer of Russia, whereas Russia is an energy producer and a key supplier of the EU, there are also distinct preconditions for energy policy and the functioning of energy sectors: the EU is a market-orientated and rules-based entity, while Russia has a political economy with a state-guided energy system. For the mutual relationship this means among other things that energy cooperation is also the encounter of a regulatory power with a geopolitical power. Finally, EU energy relations are increasing part of the foreign and security policy context between the EU or the West and Russia, with the conflict in Ukraine since 2014 being a catalyst of such a development. Hence, EU-Russia energy relations are increasingly politicized, asymmetric and securitized. Against this backdrop this paper examines EU-Russian energy relations between 2000 and 2019. In a first step, the paper provides figures and facts about the development of hydrocarbon imports from Russia to the EU. Then, it takes a historical retrospective and explores the ups and down of EU-Russian energy relations. The official energy dialogue between the Russian Federation and the EU was inaugurated in 2000. Since then, natural gas trade has received most of attention because of its historical relevance as part of the rapprochement and détente during the Cold War, diverging historical experiences in Eastern and Western member states and the Russian-Ukrainian gas crises. Since the annexation of Crimea in 2014 and the ongoing fights in Eastern Ukraine, the geopolitical dimension of natural gas trade and pipelines has become predominant. And finally, it concludes with some considerations about the prospects of mutual relations.

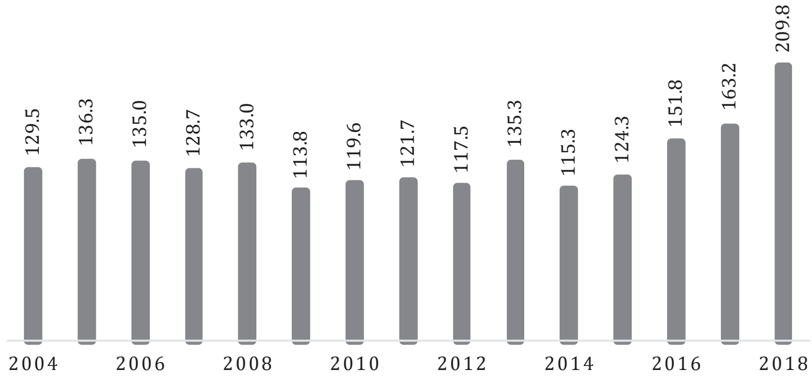
The characteristics of EU-Russia energy relations

Energy relations between Russia and the EU are based on hydrocarbons. European Member States and Russia/the Soviet Union have a long-standing energy relationship which originated in the 1950s for oil deliveries and for natural gas supplies in the 1970s. Russia's exports of hydrocarbons to Europe have shaped the relations. Yet, this has to change, because both have committed themselves to address climate change under the Paris Agreement of 2015.

EU-Russia energy trade. Some basic figures

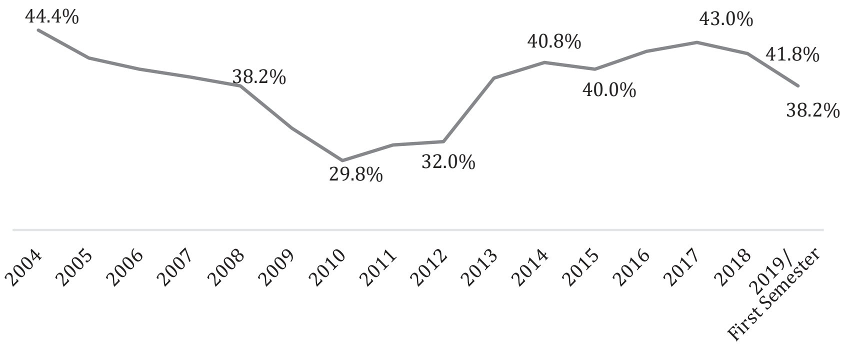
Quantifying Russia's position in the energy landscape can be done straightforward[1]: Russia is and will remain among the biggest energy exporters in the world. It produces 12.1 percent of world oil and 17.3 percent of gas and 5.6 percent of coal.[2] Accordingly, Russia is the most important energy supplier to the EU with 43 percent of its gas, 30 percent of its crude and 42 percent of its oil products originating from Russia in 2017 (see graphs below). Last but not least, the share of Russia in the EU uranium supplies accounted for 18 percent[3] and uranium enrichment services for 25 percent.[4] This is of strategic relevance, given the fact that the replacement of specific fuel rods cannot easily be realized. Russia is also a major supplier of coal to the EU. At the same time, the EU is the major destination for Russian energy exports (see graphs below).

Graph 1: EU-28: Natural gas imports from Russia (in bcm)



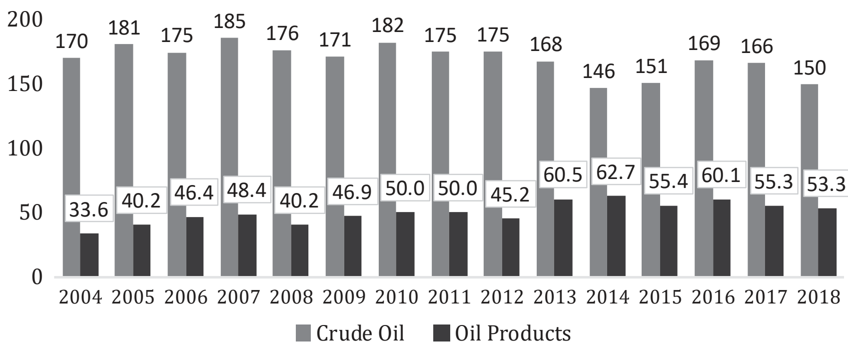
Source: https://ec.europa.eu/energy/sites/ener/files/documents/quarterly_report_on_european_gas_markets_q4_2017_final_20180323.pdf

Graph 2: EU-28: Share of total natural gas imports from Russia (% of extra EU-28 imports)



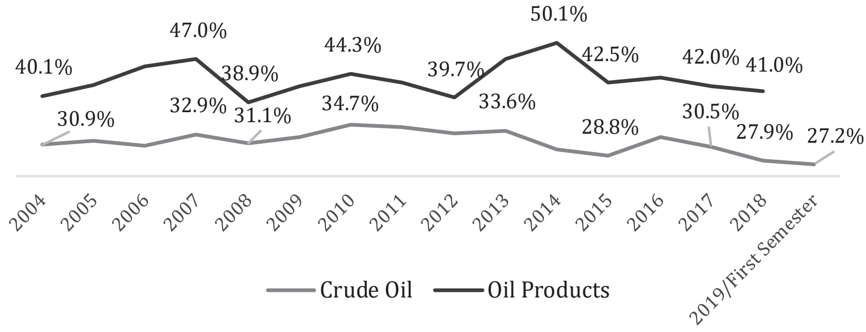
Source: https://ec.europa.eu/energy/sites/ener/files/documents/quarterly_report_on_european_gas_markets_q4_2017_final_20180323.pdf

Graph 3: EU-28: Crude oil product imports from Russia (mln. tons)



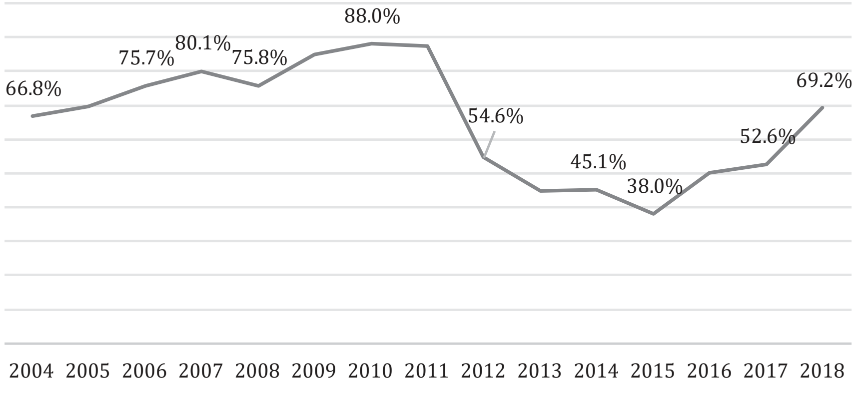
Source: Eurostat Trade.

Graph 4: EU-28: Share of Russia crude oil and oil product imports (% of extra EU-28 imports)



Even though the close energy relationship between EU and Russia stretches beyond natural gas, namely, to oil, hard coal, nuclear fuel cycle and the power sector, the EU-Russian gas relations receive most of the political and public attention as these supplies are pipeline-bound. This creates closer and more rigid (inter)dependencies. Crude oil and hard coal are traded globally. Electricity cooperation is decisive for modernization of the network and generation capacities, related to renewables and energy efficiency. Yet, the trade between the EU and Russia is limited to Finland and the Baltic States. The plans to de-synchronize the Baltic States from the former Russian/Soviet UPS/IPS and synchronize them with the ENTSO-E grid by 2025 will diminish cross-border electricity trade.

Graph 5: Russian Federation: Share of total electrical energy exports to EU-28



Source: Federal Customs Service, Customs Statistics of Foreign Trade.

Russia is a hydrocarbon exporting country, and the energy sector is of systemic relevance for the Russian economy and Russian politics.[5] the revenues of oil and gas exports account for almost half of all foreign currency earning and for almost a third of all state revenues.[6] the Russian oil and gas sector accounts for more than a third of the GDP; Russia's state-dominated behemoths, Rosneft and Gazprom, alone provide 14 percent.[7] the fiscal break-even point is 40 US Dollar for 2019/2020. All revenues from taxation and export duties, which exceed an oil price of 40 US Dollar per barrel are feeding the national wealth fund. The accumulated sum is increasing again.[8] Russia has mentioned to consolidate its budget in difficult times.

The development of EU-Russian energy relations

The first period: Towards convergence?

Before the EU-Russia Energy Dialogue was inaugurated, the relationship was based on the Partnership and Cooperation Agreement (PCA). It was signed in 1994 and came into force in 1997. The PCA is a fundamental agreement, concluded for ten years, that structures EU-Russian cooperation and defines the main areas for common activities among those energy with a reference to the European Energy Charter and its norms. Since 2007 it is renewed every year. The PCA was based on the declaration of common values such as democratic governance, human rights and the commitment to market structures. The "respect for democratic principles and human rights (...)"[9] and the compliance with political conditions, norms, rules, and regulations of the OSCE and the GATT/WTO were defined as a precondition to political and economic cooperation. Article 65 on energy affirms the principles of the market economy and the European Energy Charter, as well as emphasized environmental issues.

The European Energy Charter was signed in 1991 and the consecutive Energy Charter Treaty was agreed in 1994. The Energy Charter Treaty transfers WTO rules to the energy trade and thus set regulations and standards for a liberalized, transparent and non-discriminatory energy market.[10] It was very much driven by market liberal ideas and negotiated from the standpoint of a buyer. Yet, the Treaty with the Transit Protocol would have obligated Russia to implement the principles of freedom of transit without distinction of the origin, destination or ownership of the energy, and of non-discriminatory pricing. This had not been perceived as being in the interest of Russia and the country refused to fully apply the Energy Charter Treaty due to the Protocol on Transit. However, the Energy Charter Process served as a major channel to discuss energy issues for more than fifteen years.

The year 2000 became a crystallizing point in EU-Russian relations: when Vladimir Putin took office from President Yeltsin, he developed and strengthened a pragmatic policy course towards the EU.

A sign for the pragmatic and economy-driven policy course became the advent of the EU-Russia Energy Dialogue. The EU-Russian Energy Dialogue was set up in September 2000. At the EU level, the degree and structure of outside dependence become first and explicitly made situation of the discussion at some point of the instruction of the Green Paper 'Towards a European strategy for the security of strength supply' in autumn 2000,[11] which had also heightened the awareness of the importance of energy deliveries from Russia. In autumn 2000, the then President of the EU Commission, Romano Prodi, announced the plan to double gas imports from Russia and to increase oil imports. Energy cooperation moved upwards on the agenda of mutual relations.

The EU-Russian Energy Dialogue[12] has had a two-fold objective from the beginning: First and foremost it was intended to gear the flows of energy trade and investment, but second also to overcome certain antagonisms between the two differently structured markets. Second, the dialogue was directed at developing the 'energy partnership' in order to achieve a situation of mutual advantage. Therefore, the dialogue was organized as a multi-level attempt to govern energy relations by integrating participants from the political and the economic side into the several working groups and round tables.

The EU and Russia had defined short and long-term issues for the Energy Dialogue: the functioning of markets and their harmonization, sustainable development, predictable and stable supply.[13] Already at that time, the principles of market transparency and competition were emphasized by the EU as well as the issue of long-term contracts and their destination clauses. Pilot projects on energy savings in Archangelsk were kicked off. The safety of infrastructure was mentioned as a common concern. Under the header of 'predictable and stable supply', a gas pipeline through the Baltic Sea, which links the UK with Russia via Germany has been defined as a priority axis within the trans-European networks. An interconnected electricity network was a common priority. The joint use of the two satellite navigation systems GALLILEO and the Russian GLONASS in order to reinforce the safety of infrastructure and production was a long term objective. Last but not least, the improvement of the investment climate in Russia was an important issue because of the high investment needs identified at that time, as well as to develop new production sites to meet the growing European demand.

During President Putin's first term, foreign policy was characterized by an 'economization' of Russian foreign policy, which means a reappraisal of the relations with other newly independent states and a re-evaluation of the cooperation with the EU as the main trading and economic partner.[14] In this situation, the idea of 'a single economic space' with the European Union emerged and was translated into the 'four common spaces' at the St. Petersburg EU-Russia Summit in May 2003. Energy was part of the economic space.[15] Yet, this formal declaration had to be filled with substance and this proved to be more complicated.

2004 was a decisive year: the EU's enlargement took place, and the EU and Russia agreed on Russia's accession to the WTO and the Kyoto Protocol. These processes went on in parallel. The bilateral negotiations between the EU and Russia on a protocol for the accession of Russia to the WTO revealed conflicting positions: the EU raised the crucial issues of the application of international WTO standards, the opening of Russian markets and their liberalization with a special focus on the energy sector. This disclosed profound dissensions between the two partners on how and whether to institutionalize and structure the 'common economic space'. On the one hand, the EU had leverage over Russia, as its consent was needed concerning the conditions of the accession, notably the provisions of the Russian energy sector. On the other hand, Russia had intertwined the signing of the Kyoto Protocol with the EU's support of Russia's bid for accession to the WTO. With regard to environmental and climate policies, the ratification of the Kyoto Protocol by Russia on 22 October 2004 was a landmark in the Energy Dialogue, as both committed themselves to climate protection measures. As the Russian ratification was crucial for its coming into force after the US withdrawal, the EU pushed Russia to ratify the Kyoto Protocol. However, it was less a consequence of Russian commitment to fight climate change, than a result of a package deal. In other words, it reveals that the *do ut des* principle and the wish to produce a mutually beneficial situation worked in the bilateral negotiations on Russia's WTO accession – the EU had already signed the protocol in May 2004. Already by that time, a competition over zones of – then economic – influence became visible on the horizon.

It was at that time when it became clear that Russia was first and foremost interested in maintaining and securing its strategic position as the major single energy supplier to the EU. With this objective, Russia has put pressure on the EU to extend the acceptance of the existing long-term contracts for gas supplies. Because of the structural characteristics of the gas infrastructure and the huge investments which have to be undertaken to build pipelines, the EU finally accepted the Russian arguments.[16] In turn, Russia had to relent its position on the destination clause that was originally linked to the long-term contracts in order to determine the destination of the gas sold to the EU and to avoid a re-selling on the EU market. Russia exerted pressure on the EU to give up any plans of limiting imports to the EU or to member states from a single non-European supplier to 30 percent of the overall consumption.[17] Moreover, Russia has been interested in advanced technologies and financing.

All in all, the EU-Russian energy dialogue had been successfully used by Russia to 'monopolize' its position as a strategic energy supplier, as the EU gave up two important principles of diversification by accepting the Russian demand for the maintenance of long-term contracts and the absence of quantitative restrictions on fossil fuel imports. This was later extended to the new member states in the Joint Statement on EU enlargement.[18]

The second period: Diversity and divergence

After EU enlargement, the EU integrated new member states with a different historical background in their relationship with Russia. Energy security issues were increasingly subsumed through the lens of import dependence. The reliability of Russia as an energy supplier was more and more questioned. Moreover, the Russia-Ukrainian transit crises in 2006 and in 2009/2010 raised the question of energy security.

While the institutionalized EU-Russia energy dialogue was guided from the EU part during the above described first period by the idea of *positive interdependence* which not only builds upon physical trade and financial flows from both sides, but also *constructively* builds upon a common definition and implementation of norms and rules up to legally binding arrangements, this strategy eroded after 2006/2007. Since the start of the dialogue, the EU has been pushing for regulations and the application of international law in order to facilitate trade, commerce and investments in the energy sector. The dialogue was geared towards establishing common norms and rules for a level playing field or even one common market for energy from the EU part. Of course, this approach was also aimed at allowing western companies to have full access to the Russian energy market, but it was also perceived a crucial element to secure energy supply to Europe.

In sum, the differing interests between the supplier and consumer became more and more evident: Russia as a hydrocarbon rich country has pursued a strategy to maximizing resource rents and ensuring national sovereignty over natural resources. President Putin has also used the energy sector as an instrument of its power preservation. The 'old system of oligarchs' which had dominated the oil industry in the 1990s under then President Yeltsin has been substituted by a web of 'loyalists' to President Putin. The turn of the oil markets and increasing oil prices backed his strategy. The break-up of Yukos and the detention of its CEO Khodorkovsky in 2003 proved to become a watershed. Putin established a "network state capitalism"[19], which builds upon close control of the Kremlin and personal ties to President Putin. The big companies are managed by Putin "Loyalists" and have served as a funding source to subsidize other economic activities of a circle close to the leadership.

The EU, in turn, followed down a different path as a consumer market. The EU has had contrasting interest in cost-efficient energy supplies and implementing competition. The Internal Energy Market Packages for Electricity and Gas (1996/1998; 2003; 2009) [20] were dedicated to this end.

The most incisive change was the Third Energy Market Package of 2009. Since 1998, the EU has been passing through a sensitive transition that has gripped on policies, market structures, companies and commercial transactions as part of the Internal Market Packages. When the EU Commission started to revise long-term delivery contracts and to bring an end to 'bundled' business models with the Internal Market Packages of 2003 and 2009, the market structures and business models changed fundamentally. In particular, the Third Energy Market Package of 2009 (together with the Lisbon Treaty of 2009) to implement a really competitive, functioning and integrated EU market for electricity and natural gas has changed the consecutive bilateral energy relations on different levels. It highly affected the business model of all gas undertakings, and Gazprom among those. Its fundamental impact was even intensified by the gas glut which enfolded in 2009/2010 as a consequence of the fracking revolution in the US and surplus of LNG volumes available. This turned natural gas markets into buyers' market.

Russia has always been very clear about its historical preference for the traditional organization of the gas market, fitting with its market order. Moreover, the business cases and economics e.g. for Gazprom's infrastructure projects Nord Stream and South Stream have changed under the Third Market Package. At the same time, Gazprom has also profited from the changes, because it enabled the company's downstream expansion in Europe, and mostly in Germany. The Internal Market Packages of the EU brought a caesura in long-standing relationships, because they brought an end to bundled business models and initiated a revision of long-term contracts.[21]

Despite the stated common goal of market harmonization, diverging positions over trade, transit and investment became evident during this phase. Moreover, the issue of gas transit moved to the forefront. The transit countries Ukraine and Belarus that are geographically and physically part of the market had not been included into the bilateral dialogue, and the Transit Protocol of the Energy Charter Treaty was under constant negotiation. The year 2009 also marked a caesura in the transit dimension. The EU was affected by the Russian-Ukrainian gas crises. While in the aftermath, the EU made considerable improvements on the functioning and the interconnectedness of its internal market, the division inside the EU over the perception of Russia's role and performance as a gas supplier became predominant.

Finally, Russia had never ratified the Energy Charter Treaty, formally stepping back from it in 2009. A major reason for this maneuver was the investor-state dispute between former Western shareholders of the Russian oil company Yukos and the Russian Federation, but the step also marked a further alienation between the EU and Russia.

In sum, the energy market of the EU and Russia already drifting apart, have developed in different directions: Russia remained a state-dominated 'market' and companies even experienced a reinforcement of ties to the political elite, while the EU moved toward a neoliberal competitive and integrated internal market. As a consequence, the common space has become more fragmented. The challenge for EU's approach to liberalized (gas) markets lies in the geology, as most of the reserve base is outside EU jurisdiction.

A New Paradigm: Modernization and decarbonization?

Despite of these growing discrepancies over market structures and transit, the EU and Russia developed a common roadmap until 2050.[22] It was the first (and so far the last) document which clearly focuses at the necessity of decarbonization of the relationship.

Focusing on energy efficiency and renewable energy (RE) was not a new idea – it was part of the modernization partnership of Germany and the EU with Russia in 2009/2010. Yet, by then, it had not produced the wished-for results. Since then, however, the overall environment has changed significantly in the energy and climate realm with the global oversupply and the consequent price decrease of hydrocarbons as well as the signing of the Paris Agreement. Moreover, the transitory character of EU energy policies towards a more sustainable energy system e.g. with the German 'Energiewende' became a predominant paradigm inside the EU. Notwithstanding, this would have a deep impact on the relationship with its major hydrocarbon supplier: Russia. At minimum, the energy transition adds to growing uncertainties, because the demand for fossil fuels proved more and more difficult to foresee.

Against this backdrop, Russia and the EU had confirmed this roadmap on the basis of their energy strategies and with regard to existing energy ties and future relations. The document was published in 2013; a few months prior to the outbreak of the crises over Ukraine.

In the Roadmap for EU-Russia Energy Cooperation until 2050, both outline the political significance and the economic relevance of the energy relations which have always been perceived as having "most potential to lead the European subcontinent into deeper, mutually beneficial integration".[23] the document contains chapters on electricity, gas, oil, renewables, energy efficiency plus cooperation regarding energy scenarios and the forecast. The long-term dimension of an albeit transforming partnership is emphasized by both partners, as energy markets have become more globalized, and as the EU is aiming at having a low-carbon energy system and the Russian Federation is "on path of an innovative and efficient energy sector development".[24] Cross-sectoral issues of common interest and activities are energy demand developments, price volatility, the climate challenge and the Roadmap vision to deepen and intensify energy cooperation with steps till 2020, 2030 and 2050. The strategic target identified in the paper is a Pan-European Energy Space. This underlines the outstanding role of Russia for the continent's energy supply.

Yet, the 'decarbonization paradigm' has failed to become the guiding notion for the bilateral relationship. Over the years, the diverging positions have been manifesting. In some issues – as market harmonization and market transparency – the strategies fall apart. Moreover, Russia was increasingly requesting for a special role in the "common neighborhood" and competition over the so-called sphere of – then economic – influence arose. The EU had pushed the Energy Community since 2006 to export its Acquis Communautaire to the neighborhood. This was a clear strategy not only to extend its internal energy market principles, but also to break-up Russia's political and economic power in gas transit countries such as Ukraine. Hence, the relationship became fraught with differences concerning legal norms, rules and guiding principles. This all happened against the backdrop of a profoundly changing international environment, tipping the power balance between producers and consumers. Whilst the 1990s saw a relatively low oil price level enabling consuming countries to set the rules (partly), the price grew with increasing demand from China and Asia till 2013. Since then, the shale oil and shale gas revolution in the US has tipped the power balance, making the buyers' markets again.

The case of Nord Stream 2 and the prevalence of geopolitics since 2014

The wish to diversify away from Russia was the major impetus behind the proposal of the Energy Union by then-Polish Prime Minister Donald Tusk in 2014 and this was clearly a reaction to Russian annexation of Crimea and aggression in Eastern Ukraine. This meant a qualitative change in EU energy policies with energy security ranking on top of the five dimensions. Only over the course of 2014/2015, the Energy Union's five dimensions were fleshed out by integrating the energy objectives of all EU-28 member states. The remaining four dimensions encompass creating a fully integrated internal energy market, improving energy efficiency, decarbonizing the economy (not least by using more renewable energy), and supporting research, innovation and competitiveness. With 'energy security and diversification' on top of the priorities for the Energy Union, a securitization of energy relations has happened and energy relations have become an issue of high politics.

Against the background of the annexation of Crimea and the situation in the Eastern parts of Ukraine, Germany and other EU member states have faced a dilemma between political principles and market realities. In 2017, Gazprom exported record volumes to the EU (see graph 1). This means, that the pure commercial, geographic and geological facts still persist: the proximity of Russian energy sources, existing and planned infrastructure as well as the complementarity of Russian resource abundance and the EU as the biggest net importer of fossil fuels. At the same time, politically, the functional logic of complementarity and interdependence lost its attraction in face of Russia's course in Ukraine. The political framing of the gas relations was questioned with regard to functional interdependence, easy rapprochement and positive spill-overs.

Since 2014, the crisis in and over Ukraine had not resulted in an energy crisis. Yet, it had three major consequences on the energy relations: 1) a spiral of sanctions and counter-sanctions has been started; 2) the energy dialogue was put on hold; and 3) the EU exerted regulation as a geopolitical mean with the Nord Stream 2 pipeline in focus.

First, the West reacted with sanctions on Russia's aggression. The above described topography of Russian energy elites and their ties to the Kremlin were reflected by Western sanctions which have been tailored to companies and key members of the elite. The EU has imposed sanctions in September 2014 that are also targeted at Russian shale oil and deep-water Arctic off-shore oil development.[25] Specific equipment could no longer be exported. Sanctions on the financial sector target Rosneft, Transneft and Gazprom Neft, which are prevented from raising long-term funds from European capital markets. As major Russian banks are also on the list, refinancing is getting more complicated for the whole energy sector. The EU sanctions have been prolonged ever since then for each half year (as of August 2018).

Whilst the EU and the US administration under Obama pursued a concerted approach towards sanctions, the new wave of US sanctions since the 2017 elections of President Trump have increasingly impacted on EU's energy relations. Russia reacted to Western sanctions by counter-sanctions, which reinforced the isolationist economic and autocratic political course by cutting imports. Moreover, the Ruble's devaluation made Russian goods more competitive.[26]

Second, the Ukrainian crisis became a breaking point – it was a political shock and impacts resulting in a significant deterioration of the "*multi-layered architecture of Russia-EU political dialogue*" established over the last decades and the end of EU-Russia energy strategic partnership established in 2011 and a stalled EU-Russia energy dialogue established in 2000. The official energy dialogue between the EU and Russia has been suspended with the exception of some workstreams of the EU-Russia Advisory Gas Council. Besides that, the two parties also met in the trilateral talks with Ukraine to secure natural gas transit. These talks achieved an agreement in December 2019 under the mediation of Germany and the EU Commission.

Third, the EU regulation has turned away from a liberal market driven tool into a geopolitical (and geoeconomic) instrument.[27] While the split inside the EU over the policy course with Russia had been evident since the enlargement, the issue of Nord Stream 2 tipped the balance in favor of a harder economic and political stance vis-à-vis Russia. The project of a gas pipeline through the Baltic Sea from Russia to Germany was inaugurated in summer 2015. Nord Stream 2 running almost in parallel to the already disputed off-shore pipeline Nord Stream 1 was announced one year after the Crimean Shock and against the backdrop of the creation of the Energy Union. Whilst a number of member states, including the landing state Germany, emphasized its economic character, others viewed it through the geopolitical lens and as contradictory to EU's efforts to diversify. Last but not least, its character of a circumvention of Ukrainian transit was emphasized. Since then, the opposition against the project has been fierce. Poland, the Baltic States and Nordic countries were backed in their efforts to stop the project by (parts of) Brussels, and also joined by the U.S. It became evident over the course of 2015 up until today that the conflict lines run deep across the EU. What developed was a struggle over the legal authority to act in territorial waters and exclusive economic zones. Moreover, this struggle was reinforced by a conflict over substance on the matter whether regulation should become a means of geopolitics/geoeconomics rather than informed by market-liberalism.[28] These cleavages coincided and aggravated a deep divide among member states horizontally, but also vertically, namely between the Commission and Berlin, first and foremost.

In sum, Nord Stream 2 and the tug-of-war between proponents and opponents have significantly altered the regulatory regime of the EU. The EU's major tool, regulation, has been used for geoeconomic ends and to exert market power. In February 2019, an amendment to the gas directive was passed, which foresees either implementation of the Third Energy Market Package in EU's coastal waters, or derogation for existing pipelines or exemption for planned pipelines. This was a step to shake-up the business case for Nord Stream 2 and to reduce the rents from Russian gas sales.

Nord Stream 2 became no less the linch-pin for diffuse authority in the EU:[29] the traditional modes of consensual energy policy making failed given the deep-cut differences over the policy course in substance and over the ends regulation should serve for. In sum, the Commission bridged over the cleavage, but at the expense of politicizing the toolbox and expanding its authority into external energy security.[30] At the time of writing,[31] it remains to be seen how the saga about Nord Stream 2 will continue. For Germany, the landing state, which has taken a stance based on market liberalism and the then existing regulatory framework in Germany from the onset, the room of maneuver shrunk. Moreover, the consensus on the Amendment to the Directive does not equal a consensus in substance. The divide over market versus states as the predominant paradigm persists as do the diverging positions towards Russia inside the EU.[32] the shift of authority towards the Commission is only one result. The other far-reaching development is the extended U.S. influence on EU's external energy relations. As a result, the response to the Nord Stream 2 issue has not strengthened transatlantic energy cooperation, but has rather contributed to deepening existing divides. For the critics of the project it has become a symbol of alleged disloyalty on the part of their allies, whom they accuse of selling out foreign policy interests of the EU and partner countries. For the proponents of the project, U.S. action is considered to be an inhibition of their energy policies. For Germany it was especially dissatisfying that Washington imposed sanctions despite Berlin's support to reduce negative effects on Ukraine and a result ensuring the mid-term continuation of a considerable gas transit from Russia to the EU via Ukraine was reached at the end of 2019.

Since the announcement of Nord Stream 2, the U.S. has joined the choir of opponents to the pipeline through the Baltic Sea. Washington actively supported and pushed for a harsh stance, also promoting sales of its liquefied natural gas (LNG) into Eastern Europe as 'freedom molecules'. In December 2019, the Congress achieved a stop of the construction work on the pipeline by integrating the 'Protecting Europe's Energy Security Act' into the national defense budget. Even though this step was applauded by some of the member states, it should not be overseen, that the constant exercise of U.S. sanctions has and will have far reaching implications for EU's energy supply and freedom of choice.[33]

Conclusion. What next: "normalization" instead of grand strategies?

Energy relations between the EU and Russia have undergone a fundamental change. Particularly, the gas sector has been subject to adaptations, altered forms of cooperation and various conflicts, which centers on pipeline politics, the future of the Ukrainian transit, EU regulation under the Third Market Package or Gazprom's dominance in Eastern European markets.

It is evident that EU-Russia energy relations are embedded in a multitude of contexts – and the relevance of these contexts is increasing. The broader foreign policy landscape in Europe and the world, especially the return of Great Power conflicts and US-Russian efforts to mutually hedge their influence particularly in Eastern Europe are certainly a key factor, which will rather gain intensity in the next years. Similarly, the above mentioned tendency towards "securitization" and the geopolitical as well as geoeconomic component have gained prominence in mutual energy relations. Also, developments on international energy markets, like the "shale gas revolution" and above all the growing significance of LNG in (Central Eastern) Europe have also had impacts on EU-Russia energy relations. Moreover, there have been profound developments within the EU: driven by some member states and community institutions the EU has made efforts to improve its energy security. Hence, some EU member states have started ambitious policies of diversification in order to reduce the share of Russian hydrocarbons in their consumption – by building new infrastructures and/or using EU regulatory power. Also, as the EU General Court has shown in its ruling of September 2019 on the so called OPAL pipeline, member states will have to take the principle of "energy solidarity" (which is *per se* a quite fuzzy notion) more seriously. Finally, the shift of the EU towards an ambitious CO_2-reduction policy is beginning to have considerable implications for EU-Russia energy relations – even though it is not quite clear when and how these consequences will emerge. For one strand in that debate, natural gas and especially gas from Russia is a necessary resource in the transition to a decarbonized EU. For another strand in the discussion, natural gas hampers the transition process and should be eliminated as soon as possible among other things by supporting synthetic and green gas as well as hydrogen.

One of the key implications of this multi-dimensional embeddedness of energy relations and the various constellations of interest resulting from this is further conflict within the EU about how to define the overall approach towards Russia of the EU as a collective actor. This will mean a rather weak and limited political momentum for EU-Russia energy cooperation and the further advancement of its conceptual frameworks. At the same time, on the level of member states, a broad range of attitudes will continue to exist, from pragmatic energy cooperation with Russia to the (at least declared) objective of far-reaching decoupling. As a result, the main cleavage concerning energy relations with Russia will not separate the EU as a whole on the one hand and Russia on the other hand, but rather cut through the EU. In the short run, this divide could lead to fragmentation of the EU energy markets, with some countries trying to protect their markets and costly infrastructure projects from Russian pipeline gas (like in the case of Poland). The emergence of more and more regulatory restrictions, externally imposed limitations and internal disputes seem to hamper the future development of energy relations between the EU and Russia – and some might even argue that a genuine and substantial relationship will not be possible and there will be rather a set of bilateral energy relationships of some EU member states with Russia. However, in the long run, EU-Russia energy relations could embark on the way towards a sort of "normalization".

A path toward normalization may sound surprising from today's point of view. And of course normalization can only happen, if the broader geopolitical environment is not disruptive, i.e. it requires a minimal level of political cooperativeness on the part of Russia. Provided such circumstance exists, the internal developments in the EU, in European energy policy and energy policies of member states could be conducive to cooperation with Russia. Especially two factors could play a role: diversification efforts and EU energy policies on the on hand, the EU's decarbonization efforts on the other hand. First, once member states, which have a reluctant position towards energy cooperation with Russia, have overcome dependency, they can be more relaxed about e.g. gas imports. The example of Lithuania is instructive: even after the floating LNG-terminal went online, important consumers in the Baltic country buy gas from Russian producers (including Gazprom and Novatek). But Lithuania's bargaining position is stronger and given the elastic infrastructure allows for swiftly changing the routes of import, if necessary. So, both from a business and security point of view, gas imports from Russia are not done in a situation of being locked in long-term contracts and market domination by Gazprom. A similar situation might emerge, once Poland finishes its gas infrastructure projects (Baltic Pipe, extension of LNG capacities in Swinoujscie and possible construction of an additional LNG terminal in the Gdansk Bay) – with the year 2022 being the planned date for these steps. Even though Poland then wants to be in a situation, in which it does not have to buy Russian gas, it might not reduce its imports from Russia to zero if there are attractive offers (which is highly likely given LNG-prices). At the same time, among some member states with a traditionally positive attitude to energy cooperation with Russia, developments of the recent years have led to a sobering. They will continue to see Russia as an important supplier, but might also start a discussion about diversification or at least stop to consider Russia as a "strategic" energy partner. All in all, diversification and EU regulatory power can lead to more realism on the part of the EU, whereas Russia will have to learn to accommodate to new rules governing access to EU markets. Moreover, the EU has to be aware about the potentially highly geopolitical effects of synchronizing the Baltic States and Ukraine with the European continental grid. Electricity cooperation will require more political attention than in the past. Second, so far the relationship has been based mainly on hydrocarbons, whereas electricity and renewables are less in focus. They could form a new and less politicized area of cooperation provided that both, the EU and Russia, will go 'back to the future' by emphasizing the paradigm of decarbonization and innovation.

There are good arguments to rethink EU-Russian sectoral interfaces and redesign energy relations through the lens of decarbonization and green development, as both sides have signed the Paris Agreement. Moreover, business relations as well as interconnections between the European continental grid and the Russian Unified Power System still exist. Finally, if an energy transition is to be accelerated globally, it makes much sense to develop partnerships between "frontrunners" and hydrocarbon-abundant countries. The slow but steady shift in Russia toward supporting RE opens a window for cooperation with the EU. There is considerable room for improvement and European expertise in the areas of renewable, local, and decentralized energy; in technology and know-how exchange; but also in the business-to-business format, which could contribute to a more transparent, flexible, and business-friendly environment for the Russian RE market. With regard to innovative technical solutions, mutual and cross-sectoral benefits can be exploited in the areas of hydrogen and other gases. Small-scale liquid-/compressed natural gas backup solutions could be taken into consideration as well, for example where co-generation in remote/decentralized areas is necessary, thereby exploiting ways to replace diesel generators. Small, local CHPs with the flexibility to shift between power and heat production for large public buildings, shopping malls, etc., provide opportunities as well.

If "normalization" really happens, it remains to be seen. But what seems to be clear is that the era of grand strategies based on the hope that energy cooperation will consolidate political relations as well or even provide for traction is over. Energy relations between the EU and Russia will not be easy, but they could be less ideological and less overburdened.

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Russia-China Economic Relations under Putin Version 4.0

Vita Spivak

"Remembering the history of the Russian-Chinese relationship, we can confidently say that it has honorably withstood the test of time" – said the Russian president Vladimir Putin to the Chinese leader Xi Jinping while congratulating him on the 70th anniversary of the establishment of the bilateral diplomatic relations between Moscow and Beijing. Despite the positive rhetoric of the current leaders in Russia and China, in the past seven decades, the bilateral relationship has undergone numerous ups and downs. In the economic realm, the balance of power has changed dramatically: if 70 years ago Beijing depended on Moscow's investment, trade, and technology, in the last five years Russia has grown dependent on China's exports, financing and investment.

Chinese and Russian economies are becoming more complementary. China is currently Russia's #1 trade partner and has enjoyed this status for over a decade. The shares of its investment and financing in Russia is gradually growing. Moreover, despite the regime of Western economic sanctions, it is willing to buy Russian hydrocarbons and weapons. Yet, the economic pillar of the Russian-Chinese rapprochement uncovers Beijing's upper hand in this relationship. While the mutual compatibility and dependency between China and Russia is growing, economic cooperation demonstrates how imbalanced this partnership is.

Western sanctions against Russia play an ambivalent role in its relationship with China, especially in the economic sphere. Initially, Moscow had hoped that Beijing would replace the West as a source of cheap financing, investment, and the supply of critical industrial equipment, and the sanctions boosted Russia's "pivot to China". Yet, the lack of long-standing economic ties between Russia and China, the specific features of China's own economic development, and its priorities of foreign economic cooperation with the outside world made Moscow face the limitations of such relationship. Also, the bumpy road of economic cooperation with China showed Moscow that it needs a more competitive-oriented approach in dealing with its eastern neighbor.

The economic relationship between China and Russia: increased compatibility and interdependence

To understand the current tendencies of the Sino-Russian economic cooperation and to estimate what is going for the years to come, it is important to trace back the events in the economic relationship that took place after 2013–2014. Around this time, Xi Jinping took power in China and Russia felt the first rounds of economic sanctions of the West induced by the Ukrainian crisis. Deprived of the cheap Western financing and long-established economic ties with European business partners, Moscow turned to its biggest neighbor in the East in the hope that China would substitute for the Western partners not only in geopolitical but also in the economic sphere[1].

After 2014, Moscow's attitude towards its eastern neighbor has undergone several shifts, which underpinned the overall economic rapprochement between China and Russia in recent years. Before 2014, Moscow was primarily preoccupied with building its economic relationship with the West, supplying hydrocarbons to Europe, raising cheap financing on the western capital markets, investing the wealth of the elite in the real estate in the luxurious areas of Europe and the US[2]. Moscow was cautious about letting the Chinese into the strategic sectors of the Russian economy, hydrocarbon, and military industries, anxious about a possible intellectual property theft or strategic threat that China's development posed for the Russian Far Easters regions.

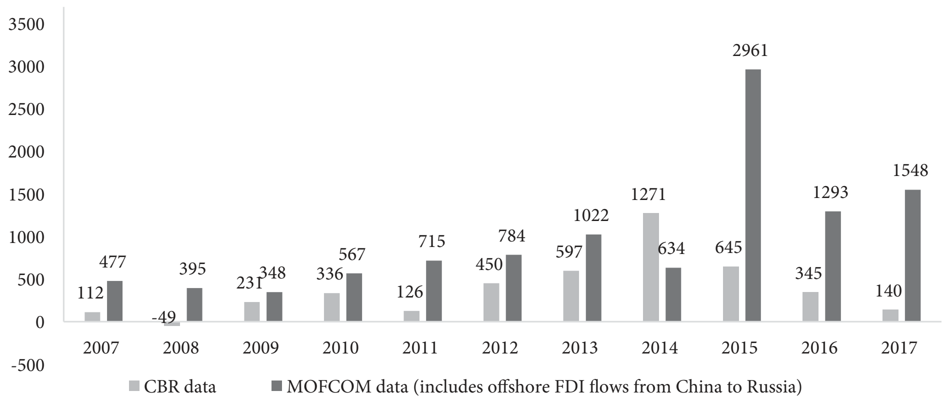
While the attention to China's economic rise was spurred in Moscow after 2008, when Beijing outperformed almost every country in the world in handling the global financial crisis, the Russian "pivot" to China started to become increasingly apparent during Vladimir Putin's visit to China in May 2014. Gazprom and CNPC signed a headline-making $ 400 bn gas supply contract, which included the construction of the "Power of Siberia" pipeline (the supplies have started in December 2019). As the tensions with the West were increasing in 2014, with this contract, Moscow managed to send an important signal to the outside world that it was able to diversify its foreign policy as well as the flows of its hydrocarbons. This message appeared to be way more important to Moscow than the fact that the contract price per cubic meter of natural gas, according to expert calculations (the official price was never officially disclosed), is below the market level.

After the 2013–2014, several important shifts in Russia's attitude towards China and its economic activities took place. Moscow has become more willing to let Chinese companies and investors into the strategic sectors of the Russian economy, i. e., oil and gas industry. Also, Russia had started to sell China its most advanced weapons, unlike in the period before that, when people in Moscow believed that the Chinese would just steal its military technologies[3]. Finally, Russia has grown to welcome Beijing's Belt and Road development initiative, which includes massive investment in Central Asian states or Belarus that have long been considered as Moscow's "sphere of influence"[4]. Russia is now starting to compete with former Soviet republics in order to attract Chinese loans and investments. In the spheres of hydrocarbon exploration and military technologies, Russia has somewhat of an advantage over China at the moment, which is seeking to diversify its energy consumption and develop its military capabilities.

Investment cooperation: Russia as a junior partner, competing for Chinese FDI

After years of growing investment expansion of Chinese companies, Beijing became one of the foremost foreign investors in the world[5]. Meanwhile, Western economic sanctions combined with changes in commodity prices and economic stagnation limited the sources of FDI for Russia. In 2013, a survey among over 900 Chinese companies (including SOEs, private firms, and joint ventures) by the Asia Pacific Foundation of Canada put Russia as a top-five preferred investment destination for the next five years[6]. However, from 2013–2017, Russia did not considerably improve its position among the investment priorities of Chinese companies, never ranking higher than the ninth place as an FDI destination, and usually remaining between 15th and 16th. According to MOFCOM's reports in 2013–2017, Russia's share of China's annual FDI flows globally hovered around 0.5–1.%[7].

Graph: Chinese FDI in Russia according to the Central Bank of Russia and the Ministry of Commerce of China (millions USD)[8]



Source: the Central Bank of Russia, Ministry of Commerce of the People's Republic of China

China is also not the biggest investor in Russia: its share of total annual FDI flows that came to Russia from 2013–2017 peaked in 2014–2015 at six to nine percent, while remaining at the level of 0.5–1% in 2013, 2016–2017[9]. The rise in 2014–2015 can be explained by a few multi-million-dollar Chinese investments into the Russian energy sector, which will be briefly described below. The quantitative data have discrepancies but provide a rough sense of the scale of China-Russia investment cooperation.

In 2017, 38.7% of China's FDI in Russia targeted extractive industries, including oil, gas, and minerals. Another 18.7% of Chinese FDI in Russia targets agricultural, forestry, and fishing industries (they are joined together in MOFCOM's reports). The financial sector is the third-largest sphere (8.7%) in the Russian economy for Chinese investment in 2017.

To attract more Chinese investments to small-sized projects, Moscow started to promote investment support mechanisms in the Russian Far East, which is located right across the border from China. After 2014, Russian authorities created several special economic zones (SEZs) in the Russian Far East – 19 advanced special economic zones (ASEZs) and the Free Port of Vladivostok (FPV). According to the idea of the creators, the Russian Far East as a region should be attractive to Chinese business: it is geographically and culturally proximate to the Asia's most rapidly emerging markets (such as South Korea and China) and should have benefitted from the general rapprochement of Moscow and Beijing. Nonetheless, out of $ 140 bn of Chinese FDI in Russia in 2017, only two percent has been invested in this region, despite Moscow's establishment of SEZs to attract FDI[10]. Such a modest amount of Chinese FDI can be explained by the size of the market in the Far Eastern Federal District: even though it covers 40.6 percent or Russia's territory, its share in the country's GDP is only four percent. The analysis of the dynamics of Chinese investments in this region demonstrates the major issues with private Chinese investments in Russia. Furthermore, with the development of the investment support mechanisms and the aspiration of the Russian leadership to diversify its economic relationship with China, the case study of the Far Eastern special economic zones might become useful for understanding the major issues of the bilateral economic relationship.

Overall, there are 20 SEZs in the Russian Far East, but only six of them managed to attract Chinese FDI, and the results of this process are mixed at best. The FPV has 34 Chinese-led projects, which pledged to invest $ 510 mn within the next three-five years. Five other SEZs together managed to attract 11 Chinese-led projects, which promised to bring $ 35 bn of FDI to. However, these investments are "contracted", not actual: in 2015–2018, the total amount of real Chinese investments in the Russian Far East has only reached $ 38 mn. Out of 45 projects in the six SEZs that attracted Chinese investments, only five have started operating so far. The majority of them have been at preparatory stages for years due to the red tape and the lack of infrastructure. Chinese-led projects in ASEZs tend to have manufacturing profile according to the industrial specialization of any given ASEZ that they reside at. The majority of Chinese investments in the FPV goes into sea farming, the real estate development and logistics (as there is lack of housing and transport infrastructure on the vast territories of the FPV). Minor shares of Chinese FDI in the FPV come in forestry[11] and mining industries, respectively.[12]

Relatively small amounts of Chinese FDI in these zones can be attributed to the lack of support from the authorities amid weak formal and informal institutions in Russia. The Russian subnational authorities tend not to trust Chinese companies, seeing them as competitors for resources and failing to provide adequate backing for the existing FDI support mechanisms, such as the FPV. In the absence of the authorities' support, low-level Chinese companies become exposed to the long-standing flaws of the Russian investment environment, i. e., red tape, power abuse, lack of infrastructure. Sometimes, the personal connections between Chinese and Russian businesspeople substitute for the lack of systemic formal and informal rules of the game and play a crucial role in attracting small- and medium-sized Chinese investors to the Russian market. Russian patrons of Chinese-led projects serve as the point of entry to the informal networks and provide protection. Such connections and support, nevertheless, remain sporadic and are unable to substitute for the systemic rules of the game[13, 14].

Investment cooperation in the energy sphere: high-level support and large-scale projects

After 2013 Russia surpassed Saudi Arabia and became China's leading crude oil supplier. As for 2018, Russia's share among China's crude oil suppliers reached 15.8%. In comparison to 2017, the value of Russian exports of crude oil to China rose by 58.6%, while Saudi Arabia's (its share among exporters to China accounts for 12.4%) value of crude oil exports increased only by 44.6%[15]. However, according to Platts Analytics, Russia might soon lose its leading positions again to Saudi Arabia. According to the 2018 data, Russia's capacity to supply China with oil has already reached its ceiling, and the country does not have the necessary energy infrastructure in its eastern regions.

Nevertheless, the boost in energy-related economic cooperation between China and Russia in the recent five years might be attributed to a mixture of factors. As tensions with the West over the Ukrainian crisis started to emerge, Russia has not only started to diversify its energy exports in favor of China but also has welcomed more of Chinese investments into its energy sphere. Such openness to China's investments is something that was not common before as shares in energy projects, companies, and hydrocarbon fields were considered as assets of strategic state importance.

In 2013–2018, Chinese and Russian companies signed several multi-million-dollar deals that involved state or quasi-state actors from both Chinese and Russian sides and often took place amid the high-level summits of the state leaders. The investments of CNPC and the Silk Road Fund (SRF) into Yamal LNG run by Novatek are one of the examples for this kind of energy cooperation: Chinese investors jointly own 29.9% shares of Russia's largest Arctic liquefied natural gas project. Other instances include the acquisition of two 10% stakes in Sibur, a Russian petrochemical company, by Sinopec, a Chinese energy giant, and the SRF. A Chinese gas trader Beijing Gas Group Company bought a 20 percent stake in the Verkhnechonsk gas field in East Siberia that belongs to Rosneft. Also, Chinese Highland Fund that is established with the backing of the provincial government of Yunnan province bought a 13.3% stake in a joint venture of Norilsk Nickel for the development of a copper mining project close to the Russian-Chinese border[16].

These multi-million-dollar deals appear in the spotlight of China-Russia broader rapprochement of 2013–2018 and often create an image of the blossoming investment cooperation. However, this high-level cooperation remains at the level of several deals and has not considerably expanded since 2016, despite Russia's willingness to promote investment cooperation with China. The most recent deal on the acquisition of a 14% Rosneft stake by a Chinese energy giant CEFC did not follow through because of the arrest of the CEO of the Chinese company upon corruption allegations.

Yamal LNG as a significant case of China's energy investment in Russia

Among several important investment deals with Chinese actors, Novatek's Yamal LNG project stands out in terms of the scale and the diversity of forms of Chinese participation. At the moment, Yamal LNG is the most significant LNG project in Russia. Yamal LNG is located in the Russian Arctic, an essential area for Moscow's strategic agenda due to its vast natural resources and the opportunities to develop the Northern Sea Route (NSR). Chinese investments into Yamal LNG became one of the highlights of China-Russia broader cooperation in 2013–2018.

Furthermore, this case might become a model for Novatek's another project Arctic LNG-2 where two large Chinese investors, energy giants CNPC and CNOOC, are involved as well. Arctic LNG-2 is located just 70 kilometers away from Yamal LNG and taps the resources of the Utrennee gas field, the proven resources of which reach 1.9 trillion cubic meters of natural gas. The capacity of the three modules of the new project reaches 19.8 mn tonnes of LNG annually. In April 2019, CNPC and CNOOC pledged to invest $4bn to acquire 20% share of this project, which will become one of the signature Chinese-Russian economic cooperation projects in the years to come. Also, this is the biggest investment Chinese companies have ever made in Russia. Notably, Chinese side is the biggest foreign investor in this project: 60% of the shares belong to Novatec, 10% – to the French company Total, and another 10% to a Japanese consortium of Mitsui and Jogmec. To estimate the scope of Chinese-Russian cooperation within this ambitious project, it is useful to investigate the details of the partnership between Novatek and Chinese companies within Yamal LNG, the project of similar nature and scale.

Yamal LNG received significant China's interest and support from Moscow. It taps the resources of the South Tambey gas field with proven and probable natural gas reserves of 926 bn cubic meters. Yamal LNG went into full operation in late 2018, increasing Russia's share in the world's LNG exports from four to eight percent. In 2018, Yamal LNG produced 17.4 mn tonnes of LNG, and once the project goes into full capacity, the production level will reach 18.5 mn tonnes annually[17].

Yamal LNG is resource-rich and located in a strategic area, but it is clear how the investments in it could be risky for Chinese firms. Novatek experienced sanctions pressure after the Ukraine crisis because of its two principal shareholders, Gennady Timchenko and Leonid Mikhelson both are the top-five richest individuals in Russia who belong to an "inner circle" of Vladimir Putin. In 2016, after the Ukraine crisis, Novatek was placed under "sectoral sanctions" that closed its access to Western capital markets and energy equipment. Gennady Timchenko was also personally placed under the US sanctions. These factors considerably compromised Novatek's ability to receive foreign investments and financing.

China's FDI in the sanctioned Yamal LNG were politically significant for Moscow and Beijing who sent a signal to the outside world about their ability to orchestrate multi-layered cooperation amid geopolitical difficulties. It also became a manifestation of the "geopolitical rapport" between Putin and Xi: they personally oversaw the signings of both deals between Chinese investors and Novatek[18]. In December 2015, Moscow and Beijing signed an intergovernmental agreement on cooperation within Yamal LNG, confirming its high status for bilateral relations.

Since the anti-Russian sanctions limited Moscow's access to Western financing and technology, it has been seeking to develop the Arctic's resource and logistical potential with China's help, which has the financial and technological resources for it. The role of Yamal LNG for Moscow's strategic interests allowed the Russian government to provide it with multidimensional support that will also be applicable for Arctic LNG-2. In December 2013, Moscow liberalized the LNG export from Russia, which eliminated Gazprom's long-standing monopoly. This legislation change is significant for Arctic LNG-2 project as well – it is also primarily export oriented, and China most likely will become the largest consumer of its LNG. The Russian government changed ecological requirements for the Arctic exploration projects in order to reduce the environmental costs for Yamal LNG[19]. Moscow also exempted the project from export, equipment imports, and severance taxes for 12 years. In 2014, Moscow recognized Yamal LNG as a project of strategic significance to the state, which entitled it to a low-interest loan of 150 bn rubles ($ 2.3 bn) from the National Welfare Fund of Russia. The Russian government sponsored the infrastructure construction around the Yamal LNG facilities and purchased the icebreaking fleet for the project that determined Novatek's successful completion of the project[20].

The state support was the "insurance" of Yamal LNG existence and attracted foreign investors to it. The costs of the Russian government related to Yamal LNG reached $ 5.75 bn. Considering all other exemptions, Yamal LNG is hardly profitable for the Russian state. Nevertheless, such concessions supported by President Putin's influence provided Chinese investors with guarantees and secured their participation in Yamal LNG.

The support from Moscow was justified by the level of Chinese investors in the project. The investments of two Chinese companies in Yamal LNG conform to the state-driven pattern of Chinese FDI. Their state-owned status and Xi Jinping's involvement allowed both of them to overlook the risks of Russia's investment climate and the Western sanctions that prevent many companies from investing there.

In January 2014, CNPC bought a 20% share in Yamal LNG. The acquisition of Yamal LNG stake worth of $ 940 mn is the biggest deal CNPC has ever signed in Russia. In March 2016, amid Moscow's intensifying clash with the West, the SRF established for the purposes of investing in the BRI projects, acquired a 9.9% stake in Yamal LNG. Although strictly speaking, it was a portfolio investment[21], this acquisition is significant as it was worth $ 1.3 bn and happened despite the political risk related to the anti-Russian sanctions.

CNPC's investments in Yamal LNG are complemented by a 20-year contract signed in May 2014 for the supply of three million tons of LNG annually (in July 2018, Novatek started its first supplies to China). Overall, 27% of all of the LNG produced by the project will go to Chinese buyers[22]. Vast resources of Yamal LNG are attractive to Beijing as it strives to find new suppliers of LNG. China is becoming increasingly interested in natural gas in its quest for decreasing the dependence on coal in its energy consumption and replacing it with natural gas[23]. LNG as a form of gas transportation has a comparative advantage to the natural gas supplied via pipelines to Beijing as it does not involve the pipeline construction costs China has to face, for example, in the case of Turkmenistan. In order to diversify its LNG supply base, Beijing has increased its participation in the Russian Arctic projects

Researchers link China's interest in Yamal LNG to Beijing's environmental priorities and its ambitions in the Arctic exploration alongside the development of the BRI. In 2013, Beijing proclaimed itself a "near-Arctic" state and received observer status in the Arctic Council, which promotes cooperation in the region. After the launch of Yamal LNG, it was labelled as a BRI project: Beijing announced its first Arctic strategy and introduced a concept of the Polar Silk Road, as part of the BRI. Beijing's strategic interest in the Arctic is related to the logistical potential of the NSR, which provides a possible solution to Beijing's "Malacca Dilemma". Currently, three-quarters of China's energy supplies pass through the Malacca Strait in the South China Sea, a region where Beijing is experiencing major geopolitical tensions with the Philippines, Vietnam, and the US. Beijing is seeking ways to avoid the Malacca's "bottleneck" in the future, including through the means of the NSR. China's participation in Yamal LNG, therefore, is an attempt to secure its presence in the Arctic. Arctic LNG-2 will become a second serious Arctic project in Beijing's NSR endeavour.

Chinese FDI to Yamal LNG brought Chinese equipment and contractors to the project. Facing domestic technological limitations in the Arctic exploration, Novatek welcomed Chinese vendors as the anti-Russian sanctions considerably denied its access to Western equipment. China Offshore Oil Engineering Company (COOEC) built modules for natural gas processing and also delivered LNG trains for the project (the contract between Novatek and COOEC is valued at \$ 1.6 bn)[24]. This was the first project of this scale for COOEC that increased its profile as a global energy equipment supplier. Furthermore, a number of other Chinese companies of smaller scale provided the project with production lines, drilling equipment, and pipe support devices that contributed to their profile as high-class international suppliers[25].

Chinese contractors brought Chinese financing to Yamal LNG. Indeed, Export-Import Bank and China Development Bank provided Yamal LNG with two loans of the total worth of \$ 12.1 bn. Part of this joint financing was an RMB 9.8 bn loan for the project (\$ 1.47 bn) that was used to pay for the works of Chinese contractors for the project.

Financing from the ExIm Bank and CDB for Yamal LNG is an important precedent for China-Russia cooperation amid the anti-Russia sanctions. It was received despite the background of the unfolding problems of Russian business and individuals in partnership with Chinese banks. They proved to be sensitive to the anti-Russian sanctions: although Beijing never officially supported them, Chinese state and commercial banks have been denying service to Russian companies and individuals. But in the case of Yamal LNG, because of the involvement of the high-level state actors and interests from both Moscow and Beijing, Chinese state-owned banks, which are not obliged to too much risk assessment, managed to provide Yamal LNG with generous support. As anti-Russian sanctions intensify (the new round came in the beginning of 2018), Arctic LNG-2 will face similar limitations, and Novatek is likely to seek financing from the Chinese investment institutions and supplies from the Chinese vendors as well in the future.

Military trade: groundwork for a military alliance?

After 2014, the military trade between China and Russia has grown substantially and continues to evolve. Aside from strategic significance for the bilateral Sino-Russian relationship, it is also important from the economic point of view. In October 2019, Vladimir Putin announced that Moscow is assisting Beijing in creating a system to warn against ballistic missile launches. He has not gone into specifics, but it looks like Russia is selling its most advanced missile defence technology to its Eastern neighbour. Even ten years ago such cooperation was not in the cards – Moscow unofficially banned military sales to China in the mid-2000s as it was anxious about China's well-known practices of intellectual property theft and reverse-engineering in the military sphere. Such caution stemmed from the idea that China "abused" and stole Russian military technology in the 1990s, whereas in reality such practices were merely the result of the weak Russian legislation at that time[26].

The strategic stance of Russian military circles in regards to China shifted after 2014, which gave the green light to large scale military cooperation that boosted military trade accordingly. The nature of these strategic shifts lies in the understanding that China is not interested in invading the Russian Far East and is more preoccupied with the regions of East and South China Seas, Tibet and Xinjiang at home rather than the territories of its northern neighbour[27].

In 2015, Russia and China signed a deal on the supply of 24 Russia's most advanced jet fighters SU-35 for $ 2.5 bn. Also, at that same year Russia's Rostech reached an agreement with China on the supply of its most sophisticated anti-aircraft missile system S-400 for $ 3 bn. While the sums of the deals were not extremely significant – the fact that Russia is selling its weapons to China underpins a strategic shift in the bilateral relationship that will continue in the years to come. The newly announced cooperation on the early warning missile defense systems also involves a significant amount of commercial deals that underscore Moscow's interest in such cooperation with Beijing.

Russia's growing dependence on China in the financial realm

Initially, when the Sino-Russian rapprochement just started, the financial part of the bilateral relationship between Moscow and Beijing has not been the top priority due to the volatility of the Russian currency and the lack of experience on both sides in interacting with each other. However, as the economic dependency of Russia on China is growing and the sanctions pressure is turning into a permanent feature of Moscow's foreign policy and economic relationship with the outside world, the financial cooperation with Beijing is becoming increasingly important. With the introduction of the new package of western sanctions against the state-sector of the Russian economy and a number of Russian individuals close to the "inner circle" of the president Vladimir Putin in the beginning of 2018, Moscow needed to send another signal to the outside world about its growing economic ties with China. The importance of financial cooperation between the two countries, therefore, is becoming increasingly prevalent in the high-level geopolitical rhetoric of the top officials.

Right after the new package of sanctions hit in 2018, the Russian Central Bank transferred 15% of its reserves into RMB. Currently, the Central Bank holds 25% of the global reserves in RMB. However, in 2019 RMB fell to its lowest level in over a decade due to the trade war between the US and China, and the losses of the Russian Central Bank already account for $ 3 bn (yet, they could be won back due to the high yields on the Chinese capital markets).

The major part of such rhetoric is an aspiration of Moscow and Beijing (that is being renewed at every high-level bilateral summit between the two countries) to increase the share of national currencies in the bilateral trade that would inevitably lead to "de-dollarization". One of the means to reach that goal is the bilateral currency swap established in 2014 and renewed in 2017. The volume of the swap line is 815 bn rubles and 150 bn yuan[28]. Yet, the share of RMB in the trade flows that go from China to Russia accounts for 25% (the share of ruble is only 4%); in the trade settlements on the trade flows from Russia to China the share of RMB accounts for 10% and the share of ruble is 7%. Moscow and Beijing did manage to decrease the role of the US dollar in the bilateral trade settlements over the last few years, but it mostly happened due to the increase of the euro's share. RMB and ruble cannot replace the traditional currencies used in the bilateral settlements: Chinese yuan is not fully convertible, and the Russian ruble is overly volatile[29].

Conclusion

Over the past five years, Sino-Russian economic ties have transformed into a complicated yet complementary relationship. Moscow is willing to cooperate with Beijing in strategic spheres of the economy and to make concessions for China to receive its investment financing and technology. Beijing is using Russia's energy and military to achieve its strategic economic and geopolitical goals.

The China-Russia economic relationship is highly practical, yet largely depends on the political background. Moscow's steps to facilitate its economic relationship with China are caused by the lack of European alternatives in financing, investment, and technologies. As sanctions are becoming a reality that Moscow has to adjust to, its economic dependence on China is growing. The personal relationship between Vladimir Putin and Xi Jinping are also providing an important boost to economic cooperation where energy and military components prevail.

Moscow is aware that there is a room for diversification of its economic cooperation with China and is likely to put the certain effort in promoting different types of cooperation in the future. There is a prospect for Russian agricultural exports in China, especially in the light of the trade war between China and the US. There are prospects in technological cooperation between China and Russia, which includes 5G network and electronic commerce development.

Nevertheless, the economic pillar of the larger relationship between China and Russia is overshadowed by military, diplomatic, and political ties between the two countries. This aspect of the bilateral relationship is the most vulnerable to economic sanctions against Russia and is not the key driver for the relationship. In most cases, the scale and intensity of the economic ties between Moscow and Beijing are defined by low competitive ability of the Russian economy overall, Russian firms, and Russian products. The potential of this cooperation is largely dependent on the state of the Russian regulatory climate, Russian business savviness in entering the Chinese market, and the stability of the Russian economy as a whole.

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5 Dollar D., *China as a Global Investor*. Washington, D.C.: the Brookings Institution, 2016, available at: https://www.brookings.edu/wp-content/uploads/2016/07/China-as-a-Global-Investor_Asia-Working-Paper-4-2.pdf

6 Asia Pacific Foundation of Canada, *China Goes Global 2013: Survey of Outward Direct Investment Intentions of Chinese Companies.* Asia Pacific Foundation of Canada, 2013, available at: https://www.asiapacific.ca/surveys/survey-report/china-goes-global-2013

7 Ministry of Commerce of the People's Republic of China, *2017 Statistical Bulletin of China's Outward Foreign Direct Investment*, Ministry of Commerce of the People's Republic of China, 2017, available at: http://images.mofcom.gov.cn/hzs/201810/20181029160118046.pdf

[8] The data discrepancies are related to the differences in the CBR's and MOFCOM's methodology. MOFCOM data includes the FDI that arrive to Russia through offshores, and its figures tend to be bigger. The unusual year of 2014 when the CBR's data is bigger might also be related to the different methods of tracing the deals (when the agreements were signed versus when the deal went through).

[9] Central Bank of the Russian Federation, Pryamie Investitsii v Rossiiskuyu Federatsiyu. Operatsii po Instrumentam I Stranam Partneram, Central Bank of the Russian Federation, 2018, available at: https://www.cbr.ru/statistics/macro_itm/svs/

[10] Central Bank of the Russian Federation, Pryamie Investitsii v Rossiiskuyu Federatsiyu. Operatsii po Instrumentam I Stranam Partneram, Central Bank of the Russian Federation, 2018, available at: https://www.cbr.ru/statistics/macro_itm/svs/

[11] The influence of the Chinese forestry business on deforestation in Russia is a largely-discussed topic. China has been a prominent buyer of Russian timber for many years – many Chinese forestry firms migrated to Russia to create often half-legal forestry business. This created widespread fears of "the Chinese threat" to the environmental situation in Russia. Yet, the impact of the Chinese forestry business on deforestation in Russia is relatively minor to the effect of the domestic issues with forest governance. Chinese firms are mainly taking advantage of the loopholes in Russian forestry laws, corruption and negligence of Russian officials and lack of the state control when it comes to nature conservation policies in Russia (see Spivak V., The Bugbear of Chinese Deforestation: the Real Threat to Russia's Forests, *Carnegie.ru*, 2018, available at: https://carnegie.ru/commentary/77200)

[12] Far East Development Corporation, *Residents of Free Port of Vladivostok; Residents of advanced special economic zones*, 2018, unpublished.

[13] Spivak V., Why Russia's Special Economic Zones Fail to Attract Chinese Investors, *Italian Institute for International Political Studies,* 2019, available at: https://www.ispionline.it/en/pubblicazione/why-russias-special-economic-zones-fail-attract-chinese-investors-24316

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[15] World's Top Exports, Top 15 Crude Oil Suppliers to China. [online] World's Top Exports, 2019, available at: http://www.worldstopexports.com/top-15-crude-oil-suppliers-to-china/

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[21] According to OECD (2008) classification, an investment is considered as FDI starting from a 10 percent ownership stake.

[22] Kogtev Y., *Nulevoi effekt: megaproiect Yamal SPG nikak ne skazhetsya na technologicheskom urovne rossiiskikh mashinostroiteley,* RusEnergy, 2014, available at: https://rusenergy.com/ru/articles/articles.php?id=74819

[23] Guo wu yuan, *Guo wu yuan guan yu yinfa "shisanwu" kongzhi wenshi qiti paifang gongzuo fangan de tongzhi*, 2016, available at: bhttp://www.gov.cn/zhengce/content/2016-11/04/content_5128619.htm

[24] Li Y., Kong L., Liu J., Yamal LNG Project and Made-in-China Equipment Going Globally. *China Oil & Gas,* 4, 2016, pp. 13–17.

[25] Ibid.

[26] Ferrari A. and Tafuro Ambrosetti E., *Russia and China: Anatomy of Partnership*, Milan: Ledizioni LediPublishing, 2019, pp. 37–60., available at: https://www.ispionline.it/sites/default/files/pubblicazioni/report_russia-china-anatomy-of-a-partnership_0.pdf

[27] Gabuev A., Kashin V., Vooruzhennaya druzhba: kak Rossija I Kitaj torgujut oruzhiem (Armed Friendship: How Russia and China Trade in Weaponry), Carnegie Moscow Center, 2017, available at: https://carnegie.ru/2017/11/02/ru-pub-74601

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Eurasian Economic Union: Numbers and Trends

Mārcis Balodis

The fall of the Soviet Union created a lot of uncertainty in the post-soviet space regarding its future, but perhaps the country most affected was the successor state of the USSR – Russia. As a possible solution for the geopolitical reality in which the USSR had ceased to exist, thereby drastically reducing political and economic power of Russia, the Commonwealth of Independent States (CIS) was established by the sovereign states of Russia, Belarus, and Ukraine. By the end of 1991 the CIS was joined by Uzbekistan, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Armenia and Azerbaijan, with Georgia joining in 1993. The CIS integration effort evolved further in September of 1993, when the CIS member states signed the Charter of the CIS with the aim of establishing common economic space. At the very start of 1995, the Russian Federation, Belarus and Kazakhstan signed an agreement on the Customs Union to further promote the creation of mutually beneficial economic relations among the members of the Economic Union. From the outset this appeared as a genuine effort to enhance stability in the region, especially considering the fact that quite recently they had been tightly integrated. The active participation of Russia already signaled the importance of regional integration for Russia in purely strategic terms – it did not necessarily need the former Soviet states to support its own economy. Instead, it definitely needed them not to stray too far from Russia's sphere of influence and to be kept in orbit. The recent political and cultural ties provided an ideal common ground upon which the former superpower could cooperate with its much weaker partner states to salvage what prestige and political power it retained.

The next stepping stone towards closer integration was set in 2000 in Kazakhstan, when Russian Federation, Belarus, Kazakhstan, Kyrgyzstan and Tajikistan founded the Eurasian Economic Community (EurAsEC) with the sole and quite ambitious aim of creating a customs union among its members.[1] the EurAsEC served its function as a framework for future integration as in January 2010 the Customs Union (CU) was formally launched by Russia, Belarus and Kazakhstan. The newly formed CU had an executive function, namely its Commission had the power to change import duties, setting tariff exemptions and quotas as well as introducing regulations and systems on tariff policies. Political friction notwithstanding, the ambition was to create a deeply integrated and coordinated economic union in the post-Soviet region. The CU came into effect in July 2011 when the three member states agreed to remove all customs borders. This very same path of development seems reminiscent of the development of the European Union (EU) when it grew from an economic union into a political one. However, this specific route differs in that the integration is occurring in a region once combined under the flag of the USSR, sowing doubts about the true nature of the entire project.

It was quickly followed by several other transformations as the goal was to create a Single Economic Space by early 2012 and a fully integrated union by the start of 2015. To reach this end, the Eurasian Economic Commission (EEC) was established in July 2012. The EEC was a supranational executive body composed of deputy prime ministers of the member states.[2] Finally on May 29, 2014 the treaty establishing the Eurasian Economic Union (EAEU) was signed. The EAEU differs from its predecessors in that it not just promotes economic relations but also establishes common standards and practices. It also has dedicated institutions and regulations along with a bureaucratic apparatus[3] necessary to run a union of such magnitude.

This moderately quick evolutionary path then leaves an impression of fairly successful integration. However, it has also encountered significant obstacles. Most notable of these are Russia's foreign policy and its attitude in bilateral relations which has effectively accelerated the disintegration within the CIS space twice already. During the Georgia-Russia war in 2008, Georgia initiated the procedure of withdrawal from the CIS as a response to the armed conflict. Then-president of Georgia Mikheil Saakashvili even explicitly stated that the CIS has failed as a regional institution in preventing a conflict among the CIS member states to happen.[4] While in 2018, following Russia's aggression against Ukraine, the then-president of Ukraine Petro Poroshenko recalled Ukraine's envoys from CIS bodies, criticizing the ineffectiveness of the CIS as an institution to denounce Russia's aggression.[5]

This issue highlights an important systemic issue when trying to achieve cooperation with much bigger and more powerful states, in this case – Russia. Powerful states do not wish to be bound by rules. Instead, they would much rather create a system that appears to be rule-bound while also maintaining freedom of exercise of power. This allows great powers to attract smaller states under the pretense of rule-bound regimes, giving an impression of consensus and respect for sovereignty, while keeping a significant power over these same regimes and smaller states to further their own goals. In practical terms, these two occasions meant that one significantly more powerful member state of a cooperative institution could either attack or at least not abstain from aggression against a smaller member state of the same cooperative institution while the institution itself remains silent for all intents and purposes. Furthermore, the same country has remained at the helm of integration efforts.

Russia's foreign policy conduct, or rather misconduct, vis-à-vis the former Soviet countries is also a symptom of its heightened sensitivity regarding its neighborhood and its geopolitical predicament. To the West lies the European Union – the richest and largest trading block in the world. 11 of its 28 member states were ruled by communists until mid-1990's and have recorded strong and fairly consistent growth since their accession[6], providing an example of what political and socioeconomical integration is capable of. Furthermore, in 2009 the EU created the Eastern Partnership (EaP) initiative to effectively spread its values to its neighboring region in the east, including such countries like Armenia, Ukraine, Georgia, and Belarus. Naturally, Russia has been largely dismissive of the initiative, seeing it as a way for the EU to interfere in Russia's sphere of influence[7]. Having said that, the EU also provides support on conditionality – the states have to enact reforms to gain support of the EU. At the same time China in the east provides a different challenge. China's modern day power is largely built on its vast financial resources and its willingness to invest in infrastructure projects and funds without demanding any political liberalization. In the context of Eurasian region, China's One Belt One Road initiative of creating a land connection between China and the EU also provides an avenue for smaller states to cooperate with China.

As a result of these two challengers, to the East and to the West, Russia itself faces a conceptual challenge. Integrating with the smaller countries in its close vicinity is imperative to keep them in Russia's sphere of influence while being alert of what the EU and China are up to. However, the smaller states also must acknowledge the potential dangers of cooperating with Russia and that its conduct can have detrimental effects on each country that has close enough ties to Russia, while also acknowledging the potential benefits of either cooperating with the EU and/or China or at the very least leveraging them against Russia. This forces Russia to look for options to limit the foreign policy alternatives of smaller states by exercising its own power, for example through concessions, without stepping over the line which could alienate the smaller states and effectively drive them away.

The post-Soviet space had seen an emergence of a regional integration regime within 15 years since the dissolution of the USSR. However, the obvious imbalance of political and economic power as well as their differing foreign policy challenges as well as objectives beg a question of the grand strategy behind the EAEU. Is the EAEU an economic union between historically tightly connected countries with the sole altruistic aim of using the existing co-dependencies for mutual economic benefit and impetus for development or has the union been established for political gains by creating a regional institution to legitimize political and geopolitical ambitions.

Differing political perspectives: reasons for regional integration

Regarding the potential imbalance of power due to Russia's participation in the EAEU, it is worth to explore the foreign policy concepts of Russia for the potential role of integrating the CIS and its successor institutions as a means of furthering Russia's goals. The foreign policy concept of 2000 clearly states that Russia will seek further integration in the CIS region in terms of economic, political and security integration. However, it is also explained that Russia will define the character of its involvement with the CIS region as a whole due to different levels of integration in the region, therefore priority is given for strengthening of relations with Belarus.[8] Meanwhile the foreign policy concept of 2008 already states a specific aim – to establish a customs union and common economic space through EurAsEC and to strengthen it as a core mechanism of economic integration[9], thus emphasizing a clear difference not just in the end goal of integration, namely the EAEU, but also in integration as an end in and of itself. The foreign policy concept also clarifies that Russia's willingness to be a part of subregional institutions in the CIS region depends on multiple factors, one of which is their compatibility towards already existing cooperation mechanisms such as EurAsEC.[10] the change in policy planning indicates a shift in perception, in that EurAsEC has now become a fixed element in the post-soviet space and its function is vital for further development.

By 2013 Russia's attitude towards integration in the CIS region had evolved further and was clearly reflected in the Foreign policy concept. Creation of the EAEU now had become a priority with the goal of not just strengthening economic development in the region and becoming a model of association open to other states, but also to become a link between Europe and Asian-Pacific regions.[11] This marks a considerable difference in foreign policy strategic planning as the EAEU is apparently intended to become a true actor on the global stage, which is in stark contrast of purely economic integration in the region that was formulated just five years earlier.

Finally, the Foreign policy concept of Russia of 2016 clearly states that strengthening of the integration within the EAEU is a key objective to promote development, technical advancement, competitiveness of the member states and improvement of living standards. The most interesting addition is the claim that one of the goals of the EAEU is the harmonization of integration processes not just within the CIS region but also in Europe, Eurasia as a whole and Asia-Pacific.[12] Thus it is apparent that the regional integration effort has become a priority for

Russia with the aim of establishing a regional union as a major political actor on par with the major actors in the East and the West. It becomes obvious that Russia has noticed a significant trend and is looking to follow it – the world has divided itself into smaller regional blocks that use resource pooling to consolidate power,[13] therefore creating a regional block with Russia at the helm is a means to secure Russia's position in the current world.

An article written by then-Prime Minister of Russia Vladimir Putin in 2011 sheds lighter on this development. In the article V. Putin explains how the integration of post-Soviet space has promoted economic growth even through the financial crisis of 2008 and how the initially purely economic institutions and concepts have evolved further, for example, by establishing the EurAsEC Court that has the power to make rulings on matters regarding discrimination or violation of competition.[14] He also notes that the creation of EAEU was based on the experience of Europe during the creation and evolution of the European Union. Regarding the role of the EAEU on the global stage V. Putin clearly states that it will become one of the attraction poles in the modern world based on the natural resources, capital, and human resources available for the member states of the EAEU, thus giving it a strong position in the technological race[15]. By acknowledging the role of the EAEU V. Putin essentially explained the grand strategy, i. e., the vast amount of resources pooled by the member states is bound to materialize in a significant increase in combined political power. Interestingly enough, it already hints at a possible cause for friction, namely, the asymmetry of economic power. Russia absolutely dwarfs Kazakhstan and Belarus in terms of economic power, hinting at the difficult reality the smaller states will have to deal with – Russia is the biggest and most powerful partner in this deal and therefore will likely make its demands the main ones and will also demand a lot of political contributions from the smaller states. It is also worth noting that due to this asymmetry Russia does not gain much in economical terms, at least in the short term. What it can do, however, is use its power within the EAEU to make sure the institution represents the needs of Russia, while operating behind the façade of a regional integration organization with multiple member states and its own bureaucratic apparatus.

Interestingly an article written by then-President of Kazakhstan Nursultan Nazarbayev published just three weeks after V. Putin's article shows a similar, but not necessarily identical perspective when it comes to regional integration. He goes on to explain his four principles of integration. First, the primary driving force of integration is economical pragmatism, not geopolitical ambitions. Secondly, integration must be voluntary and each state should independently arrive to the conclusion that regional integration is necessary and beneficial. Thirdly, sovereignty is imperative. Lastly, the supranational institutions of the EAEU should make decisions based on consensus to ensure that all the different interests of member states are taken into account and that the powers of said institutions must be clearly defined. However, the supranational institutions must not limit or overrule national political sovereignty just like the European Union does not, which N. Nazarbayev calls successful.[16]

It is clear, then, that Kazakhstan was clearly in favor of economical integration, however, some of the points hint at some potential differences in interpretation of the inner workings and the end goal of the EAEU, especially the emphasis on respecting national sovereignty. Taking into consideration that at this point the integration happened mainly among Russia, Belarus, and Kazakhstan it seems that Kazakhstan was worried about the potential power abuse of Russia, for the EAEU could potentially be a thinly veiled attempt to impose Russia's will on its neighboring region behind the façade of regional integration. Moreover, Kazakhstan's economical ties to other regions, such as the European Union, are an important aspect to take into consideration when economical integration with Russia is a possibility. The president of Belarus Alexander Lukashenko also made similar points, claiming that relationships among member states should be based on mutual benefit and equality[17], which again suggests reservations about asymmetry of power and Russia's potential abuse of power within the EAEU framework.

These very same reservations seemed to be justified following Russia's conduct in Ukraine. Following the Maidan revolution in Ukraine, Russia did not hesitate to use force to change the borders of a smaller state. Both Belarus and Kazakhstan opposed Russia's suggested trade restrictions on Ukraine and Moldova as a punitive measure for their movement towards the EU. Belarus used this chance to position itself as a middle man to allow sanctioned Western products access to Russian markets through their own market. Even more so, Belarus swiftly recognized the new president of Ukraine Petro Poroshenko, took part in the inauguration, as well as supported the anti-insurgency campaign of Ukraine against Moscow-backed separatists. Meanwhile the same events caused worry in Kazakhstan and its territory of North Kazakhstan that has a large Russian population and could potentially be used to cause political instability the same way Crimea was used.[18] Russia's aggressiveness and apparent willingness to use force to impose its will has definitely caused a great deal of stress to other EAEU members and effectively forced them to look for room to maneuver in their own foreign policy vis-à-vis Russia, and it is only exacerbated by the fact that Russia guaranteed Ukraine's territorial integrity on the condition of denuclearization, effectively providing an example of Russia going back on its word and taking what it wants by force.[19] For example, in November 2019 Belarus secured a 500 million USD investment deal from China following Russia's reluctance to provide finances[20], most likely using China to leverage benefits and a more favorable treatment from Russia while also indicating that Belarus is not completely sealed off of the rest of the world.

It cannot be denied that Belarus and Kazakhstan, as well as the most of the region altogether, are too closely integrated in Russian economy and politics to significantly change their foreign policy strategies and it is unlikely that cooperation with Russia will be ceased. At the same time Belarus and Kazakhstan do realize that it is best to not step on Russia's toes too much. What Russia's continued behavior has created, however, is a certain feeling of discomfort seeing how a single state can relatively easy cause massive instabilities in other countries. As a result it is very likely that smaller countries will continue to seek a policy of hedging[21] to leverage better deals from Russia to at least offset its potential aggressiveness.

It is also worth noting that EAEU consists of non-democratic countries. For smaller countries this can create uneasiness considering Russia might use its influence to determine the result of internal power struggles. On the same note, Russia can use Ukraine as an example of how the West can cause a political stir and then abandon their allies, while Russia will remain loyal and supportive. Additionally, Russia's financial and political support is not conditioned by demands of democratization or political reforms. However, this also creates a risk for Russia. Considering the non-democratic regimes lack a system of seamless transition of power, it is possible that a new leader could potentially decide to distance themselves from Russia, therefore deepened integration could become a tool in securing unwavering political support of smaller states by effectively limiting their room for maneuver.

Accession out of necessity: Armenia and Kyrgyzstan

If Russia's goal is to create a geopolitical power with Russia at its center, the accession of Armenia is an obvious example of Russia throwing its weight around to attract or even coerce new members. In April 2012 the then-president of Armenia Serzh Sargsyan explained to the Minister of Foreign Affairs of Russia that for Armenia joining the Customs Union makes "no sense" because Armenia does not have a land border with any other Customs Union member state and therefore does not have a trade relationship that would stand to benefit from streamlined customs procedures and regulations.[22]. At the same time Armenia was negotiating with the European Union a potential Association Agreement, which would have included a Deep and Comprehensive Free Trade Area agreement and would grant access to certain sectors of the free market of the European Union. However, in September 2013 the President of Armenia after a meeting with V. Putin unexpectedly announced that Armenia would join the Customs Union and would also participate in the integration processes within the EAEU. To explain the sudden change of course, President referenced the creation of the military security structure within the CIS region – the Collective Security Treaty Organization, of which Armenia was a part of – whose members were now creating a new platform of integration, and "participating in one military structure makes it unfeasible and inefficient to stay away from the relevant geo-economic area".[23] As a result, Armenia withdrew from negotiations with the European Union and became an EAEU member in January 2015.[24]

This decision without a doubt was heavily influenced by Armenia's most pressing security issue, namely the Nagorno Karabakh territorial conflict against Azerbaijan, the latter being supported by Turkey, effectively forcing Armenia to go along with Russia[25] in hopes it would provide political backing for Armenian position in the conflict. As an added benefit, some Armenian goods were exempt from duty taxes within the EAEU, as well as specific imports from Russia such as natural gas, petroleum products, and rough diamonds. However, due to the tight economic ties with Russia, EAEU-related economic benefits were moderate at best due to international sanctions put on Russia,[26] thus providing an example of why economic diversification is important. Interestingly enough, the pro-European Union dialogue within Armenia has not disappeared and following the Velvet revolution in 2018, Armenia is looking to improve its relations with the European Union. For example, in July 2019 Armenia adopted the Comprehensive and Enhanced Partnership Agreement implementation roadmap which provides new cooperation possibilities, including financial support and access to research and development programs.[27] This indicates Armenia is looking to gain access to the European Union despite its membership in the EAEU, and that the EAEU accession was encouraged by security concerns.

Undoubtedly the weakest member of the EAEU is Kyrgyzstan, whose accession in May 2015 was clearly an effort to stabilize itself both in terms of internal politics as well as economy. The small republic has suffered from internal divides, civil wars, chronic mismanagement and border disputes, thus membership in a Russian-led integration project was deemed the best way to secure internal stability.[28] On top of that, Kyrgyzstan and Russia have established a 1 billion USD[29] Development Fund which Kyrgyzstan will have to utilize to upgrade its customs infrastructure to meet the EAEU regulations[30].

Institutions of the EAEU

The institutional structure of the EAEU appears to be modeled after the institutions of the EU, corresponding to the claim made by V. Putin in 2011. However, after closer inspection, it becomes apparent that national states have much more say in the decision making process. The EAEU has a four-tiered government structure. At the top of pyramid lies the Supreme Council (at the level of heads of state), the Intergovernmental Council (at the level of heads of government), and two-tiered Economic Commission, that consists of the Council (at the level of deputy heads of government) and the Collegium (at the level of ministers). All these bodies make decisions by consensus except for the Collegium which uses qualified majority voting. However, all politically sensitive questions are decided by the upper level of Commission to restrict Russia's ability to impose its will unto others[31], seemingly mitigating reservations about Russia's potential behaviour.

Yet, the decision making within the EAEU is largely based on political bargaining and securing certain benefits from member states to effectively buy their support and loyalty. In late 2016 Belarus boycotted the EAEU meeting effectively blocking the Customs Code from entering into force and also used this as a bargaining chip to force Russia to adjust its gas prices.[32] This is indicative of Russia's goal – it is willing to suffer short-term losses by giving in to fairly low scale short term demands, in return receiving political loyalty of member states. Moreover, if Russia is seemingly willing to make such deals to break deadlocks and ensure participation, Russia has little interest in adhering to supranational rules set forth by the EAEU and it can just use its influence to get what is necessary. Meanwhile this sets precedent for the smaller states of the EAEU that have their own reasons to doubt Russia's efforts to achieve economic integration on a basis of consensus and respect for sovereignty, therefore in this type of situation smaller states can force Russia into making concessions to offset the risk of being in a loosely organized institution with one heavily dominating state.[33] Thus Russia may have to give in to these kinds of demands from time to time to placate and appease smaller states in return for medium and long term contributions.

If the EAEU is looking to achieve ever greater state of integration, it is definitely going to need strong common institutions with the authority to intervene in matters usually left for national sovereignty, especially considering the overall low quality of governance in the region.[34] the Commission is the institution responsible for further integration and its decisions are nominally binding to all member states, but member states that disagree with the Commission's decision can take it up to the higher bodies[35]. Moreover, the main decisions are made by the Council, i. e., the national governments and heads of state, effectively creating a top-down hierarchy and opening the door for political negotiations, bypassing the common institutions and their decisions altogether. On top of that, the Commission is no longer authorized to bring the member states before the court for non-compliance, thus not allowing the institution to enforce decisions made by the institution itself and opening the door for more bilateral negotiations. Even at times when the decisions of Commission are deemed to be enforceable, the member states define their enforceability according to their national constitutions, as did the Russian Supreme Court, when it challenged the ideas of "direct applicability" and "supremacy" of the Eurasian law.[36] In a similar fashion the official judicial body of the EAEU does not have the power to change any norms or create new norms of the law,[37] essentially allowing the national governments to decide for themselves which decisions they wish to follow and to what extent, calling the ultimate goal of economic integration into question altogether.

Marriage of economic convenience

When assessing the motivation of the smaller member states to join the regional integration project, it is important to look at economic data that could potentially elaborate on the reasoning. Moreover, if the EAEU is supposed to become an economic institution, it would not be unreasonable to assume at least a decent level of economic activity among the member states.

Table 1: Basic economic information on member states (as of 2018)

	GDP, USD billions	*% of EAEU total*
Russia	1,658	86.9%
Kazakhstan	170	8.9%
Belarus	59	3.1%
Armenia	12	0.6%
Kyrgyzstan	8	0.4%
Total EAEU	1,907	

Source: World Bank[38]

In case of Belarus and its mostly concentrated trade profile, Russia alone accounted for almost 44 percent of Belarus' exports in 2017, while also receiving significant discounts for energy.[39] That being said, the International Monetary Fund (IMF) suggests that being a part of the EAEU could at least partially be responsible for the growth of GDP in 2018 relative to 2017.[40] Even despite that, Belarus accounts for only 3.1 percent of the total GDP of the EAEU,[41] while trade with the EAEU members constitutes over 46 percent of its trade overall in 2017 worth just over 13 million USD, the vast majority of which – worth about 12.8 million USD – comes from exports to Russia.[42] Meanwhile exports to the EU accounts for roughly 20 percent of its overall exports, making the EU the second main partner in trade, while in terms of imports the EU accounts for roughly 15 percent of Belarus' total imports. However, China is a significant exporter to Belarus, whose imports are responsible for almost 8 percent of all imports, while exports to China account for only just over a single percent of exports from Belarus.[43]

This shows an obvious reality for Belarus – access to Russia's economy is of utmost importance, and presumably any project that promises improved access and favorable terms of trade with Russia, is deemed worthwhile, especially considering its limited foreign policy options due to its political isolation.[44] At the same time it sends a clear signal to Russia that Belarus' integration efforts directly correlate with the economic relations with Russia, and failure to provide preferential treatment will possibly create friction between the two governments. This strategy has been implemented multiple times by Belarus, threatening to leave the EAEU in the face of Russian lack of cooperation.[45] Interestingly enough, this mutually beneficial relationship also corresponds to the institutional weakness of the EAEU mentioned earlier in that decisions made by the EAEU as a regional institution can be effectively blocked by national governments over bilateral issues.

Meanwhile Kazakhstan's participation in the EAEU is dictated not necessarily by its dependence on Russian resources and market but by its relative economic strength and already existing trade relationships both in the East and West. Kazakhstan is the second biggest economy of the EAEU, even though it accounts only for 8.9 percent of the total GDP of the EAEU.[46] In 2017, Kazakhstan exported more than 48 billion USD goods and services, and Russia accounted for less than 10 percent of that total while China accounted for nearly 12 percent, with the EU member states combined accounting for over 40 percent.[47] This is further corroborated by the World Bank data, according to which trade with EAEU members amounts to only 10.5 percent of its trade overall in 2017.[48]

Considering the statement of the former president N. Nazarbayev, the membership of Kazakhstan is mostly dictated by economic pragmatism and the benefits offered by a functioning economic union. However, N. Nazarbayev emphasized that such endeavors should not be politicized, indicating Kazakhstan's realistic perspective, i. e., a closer integration within the EAEU or even the growing geopolitical significance of the EAEU could severely damage its existing trade relationships, hence it is more inclined to uphold an economic union and generally good relations with Moscow without being a part of a larger struggle for power between Russia and its perceived rivals[49]. Moreover, membership in the EAEU by itself can create an opportunity to at least tame Russia's ambitions and clout[50] by common rules and institutions.

In terms of economic importance, Kyrgyzstan definitely stands to gain the most out of at least partial economic integration. It is by far the economically weakest member state of the EAEU, accounting for only 0.4 percent of the total GDP of the EAEU[51], while trade within the EAEU constitutes over 40 percent of its total trade.[52] Although, trade with China brings over 33 percent of the total trade of the small country[53], while imports from the EU account for less than 5 percent of total imports. Interestingly enough, exports to the EU constitute around 12 percent of total exports, with almost 11 percent of Kyrgyzstans total exports going to the United Kingdom.[54] However, perhaps the most important factor in favor of accession was the dependence on remittances from its citizens living and working abroad, mostly in Russia, that in early 2015 roughly 9 percent of the entire Kyrgyz population were reported to be in Russia.[55] On top of that, it is safe to assume many migrants are in the country or work there illegally, thus making the entire situation even direr. Additionally, about 13 percent of households receive remittances which constitute up to half of their income.[56] As a result, Kyrgyzstan has one of the highest rates in the world of reliance on remittances,[57] and membership in the EAEU along with its freedom of movement provides definite gains for the Kyrgyz economy. The benefits of easier access to Russian and Kazakhstan's markets are obvious as they both combined constitute around 30 percent or 520 million USD[58] exports of Kyrgyzstan in 2017.

The story is similar for Armenia, which, despite its lack of land borders with other EAEU members, generates around 26 percent of its trade total in trade with other EAEU member states, of which Russia is single-handedly the most important one, accounting for over 25 percent or 540 million USD of Armenian trade total within the EAEU of 551 million USD in 2017.[59] China is an important trade partner for Armenia, constituting almost 12 percent of Armenia's imports while also being responsible for over 5 percent of Armenia's exports.[60] Similarly trade with the EU is of importance, accounting for over 26 percent and 11 percent of Armenia's exports and imports respectively.[61]

At the same time, Russia's trade with EAEU members accounts for only just over 8 percent of its total trade in 2017,[62] with Belarus being the top destination for Russian exports. Russia also dwarfs the economy of the entire EAEU – Russia's GDP constitutes 87 percent of the entire GDP of the EAEU.[63] When put into perspective, the economic significance of EAEU member states seems to dwindle even more. For comparison, in 2017 trade with China accounted for almost 10.5 percent of Russia's overall trade, while trade with the EU countries combined attributed to over a quarter of Russia's exports.[64]

Table 2: Trade among the EAEU member countries

Exporting country, USD million, 2017	***Importing country, USD million, 2017***					
	Russia	Kazakhstan	Belarus	Armenia	Kyrgyzstan	Total EAEU
Russia	–	11,924	15,537	0,868	1,388	28,849
Kazakhstan	4,515	–	95	4	503	5,117
Belarus	12,835	587	–	34	123	13,579
Armenia	540	4	6	–	1	551
Kyrgyzstan	265	266	7	0,1	–	538
Total EAEU	18,155	12,781	15,645	38	2,015	

Source: World Bank[65]

The data seems to strongly suggest that in terms of economic development Russia does not score any significant wins from the EAEU. The share of EAEU economies overall is very small. Moreover, the EAEU member states are generally poorly developed and/or do not offer diversified economies which would grant Russia access to technologies to strengthen its position economically and politically. On the flipside, access to Russian economy is without a doubt a very significant aspect to all the other EAEU members, thus corroborating the practical reality of the entire integration project. Even though the smaller states may not be interested in geopolitics, the cost of not being a part of the EAEU (and, by extension, not gaining access to the Russian economy) is too great to bear in purely economical terms, while allowing Russia to employ a carrot-and-stick tactics by attracting less developed nations through the promise of tighter economic integration. This, in turn, allows Russia not just to increase its reputation but also employ the EAEU as its own foreign policy tool behind the façade of multilateralism.

Conclusion

Within 24 years since the collapse of the USSR the post-soviet region experienced, on the surface at least, a significant development in the form of the EAEU. Through many different formats it evolved as a nominally economic institution with the sole aim of improving integration and furthering the development of Russia, Belarus, Kazakhstan, Armenia and Kyrgyzstan. Upon close inspection, though, it becomes more and more apparent that the EAEU is a peculiar institution in that it is claimed to be created for economic purposes but its internal structure and inherent asymmetry of power indicates it is a part of a bigger picture in Russian foreign policy planning.

Russia dwarfs the entire institution in terms of political and economic power, while also acknowledging the importance of regionally integrated blocks as a means to turn economic power into political power. The institutional structure, albeit said to be designed after the example of the European Union, is toothless as an institution while also allowing for political bargaining and bilateral deal making, giving Russia room to use its power and influence. The membership of smaller countries is dictated either by their dependency on Russian markets or at least the necessity to uphold good relations with Russia.

Russia has entered into an economic union with 5 smaller and less developed states that does not bring Russia any economic benefits per se. Instead, it allows Russia to hold these countries within its reach for the foreseeable future and to secure their cooperation in exchange for some fairly short-term economic benefits. As a result Russia has been able to create a regional supranational institution that contains 4 Davids and a single Goliath but with a twist – the Davids are unable to significantly affect Goliath's actions due to the asymmetry of power and their limited foreign policy options. That is not to say, however, that they are unable to chip away at Goliath's power by effectively vetoing resolutions made by the EAEU and by making loud statements in order to force Russia to make concessions. Ultimately the states may have their reservations about Russian power but their membership in the EAEU achieves Russia's goal – to create a supranational regional institution with Russia at its helm to solidify and legitimize Russia's geopolitical ambitions.

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Money River from Russia to the West. How Toxic is it?

Marius Laurinavičius

French economist Gabriel Zucman has made his name on the extensive research of capital flow and hidden wealth of countries. When he had looked at Russia, as he pointed out in his book “Hidden Wealth of Nations: The Scourge of Tax Havens”, he found that around 50 percent of Russia’s wealth resided outside the country.[1]

When applying different research approaches with his colleagues Filip Novokmet and Thomas Piketty for the research paper “From Soviets to Oligarchs: Inequality and Property in Russia 1905–2016” he has come to the same conclusion: Russians own about half of total financial wealth offshore[2].

Zucman and his colleagues primarily draw attention to the problem of tax evasion and distribution of income and wealth in Russia. However, there is another problem which is posed by such flow of Russian money abroad. Namely, the toxic effect this money has on the Western countries and Western societies. This paper examines the scope of toxicity of Russian money and the historical context, which makes the argument of a snow-ball effect plausible, when it comes to neglection of the problem.

The first dimension of the threat that Russian money poses to the West refers to sophisticated criminal activities they bring with it. Russian mafia’s infiltration into Western businesses and financial institutions has been recognized as a threat for decades. However, it has been largely neglected as such for just as long. The events of recent years have made clear the futility of attempting to differentiate between the Russian mafia and the Russian state[3].

We live in perilous times when Western law enforcement agencies not only tie biggest cybertheft campaigns of the last decade to Russian hackers, but also suspects in the crime are allegedly related to Russian security services[4] and leaders of Russian criminal world[5] at the same time. These are the times when Europol highlights Russian money as the biggest laundering threat[6] and considers mafia in general a bigger security threat than terrorism or migration[7]. That is just a context in which Russian money flow to the West should be considered as well.

The second aspect which, without any doubt, should be considered when Russian money flows to the West is discussed as a hybrid warfare Kremlin wages against the West. In that context it is important to take into account that the Kremlin doesn't restrict itself to governmental and non-governmental organizations when pursuing its hostile goals in the Western countries. For example, all or almost all publicly known financing of anti-European or anti-Western activities coming from Moscow are conducted through private Russian-led businesses rather than governmental organizations.

As Mark Galleotti points out, "Moscow must also be considered the master of "hybrid business," of developing illegal and legal commercial enterprises that ideally make money, but at the same time can be used for the state's purposes, whether technically private concerns or not. Russian commercial institutions not only provide covers for intelligence agents and spreads disinformation, but acting notionally on their own initiative, they are also used to provide financial support to political and social movements Moscow deems convenient"[8].

All that makes money flow mentioned and kleptocratic means in particular an indispensable tool for Russian hybrid warfare efforts. The more so, when the same applies not only to the money, which isn't so much dark as murky, as Ben Judah and Nate Sibley put it. They draw attention to "funds that are not necessarily flat-out illegal, stolen, or laundered but instead from state-owned companies, oligarchs, or enterprises that may pose a strategic threat to the national security".[9]

Historic overview

"A capital flight is a capital flight". According to Fritz Ermarth, former officer for Central Intelligence Agency, that was the answer of US political establishment to an appeal for CIA to help finding vast sums essentially stolen by the KGB on behalf of itself and the Communist Party of the USSR and deposited abroad in the bank accounts and front companies[10]. In 1992 the logic behind such a decision was described in simple terms: it doesn't matter who has the money or how it was acquired, even if by theft; as long as it is private, it will return to do good things if there is a market[11].

As history has proved, such an assumption was tremendously wrong. From well-documented plans made public long ago, we know that the KGB and Communist Party were not interested in doing good things, neither they were interested in functioning of a real market. They sought to establish hundreds of business enterprises in the West that would provide cover for the KGB and party members to transfer assets abroad with the assistance of organized crime[12].

As the outcome of the Western approach called "capital flow is capital flow", instead of good things that should have been done by money stolen by KGB and Communist Party, a full-fledged mafia state has been established in Russia[13] over the years. Moreover, corruption has become greatest export of Putin's regime, as David Kramer, former United States Assistant Secretary of State for Democracy, Human Rights, and Labor puts it[14]. Though the transformation has not occurred over the night, red flags have not been noticed, warnings have not been heard and lessons have not been learned.

For example, on September 21, 1999 Richard L. Palmer, a former CIA officer and an expert on Russian organized crime publicly warned the United States Congress on the threat of Russian kleptocracy infiltration into the West. He himself referred to conventional wisdom, which holds that "corruption and the power of Organized Crime will diminish as capitalism and free enterprise improve economic conditions, and democratic reforms will gradually reshape the government and infrastructure of Russia, causing criminal enterprises to spontaneously "legitimize" their operations"[15]. However, in his testimony before the House Committee on Banking and Financial Services R. L. Palmer provided tons of information and a full bunch of arguments in order to prove that conventional wisdom mentioned is totally misplaced. He warned that the values of the kleptocrats could become America's own and pointed to the fact that "paper" firms make "political donations to the U.S. politicians and political parties to obtain influence."[16]

Since 2010, a testimony of Spanish prosecutor Jose Grinda Gonzalez should have been taken into account. As it was made public by "WikiLeaks", a prosecutor, who spent decades investigating crimes of Russian mafia in Spain, "stated that he considers Belarus, Chechnya and Russia to be virtual "mafia states". For each of those countries, he alleged, one cannot differentiate between the activities of the government and OC groups"[17].

In the context of Russian money flow Grinda's warning was not less grave. "Grinda suggested that there are two reasons to worry about the Russian mafia. First, it exercises "tremendous control" over certain strategic sectors of the global economy. The second reason is the unanswered question regarding the extent to which Russian PM Putin is implicated in the Russian mafia and whether he controls the mafia's actions. Grinda cited a "thesis" by Alexander Litvinenko, the former Russian intelligence official who worked on OC issues before he died in late 2006 in London from poisoning under mysterious circumstances, that the Russian intelligence and security services – Grinda cited the Federal Security Service (FSB), the Foreign Intelligence Service (SVR), and military intelligence (GRU) – control OC in Russia. Grinda stated that he believes this thesis is accurate"[18].

Having in mind his experience in a *modus operandi* of a criminal world, Grinda with shocking accuracy managed to predict a problem with Russia we face now. Spanish prosecutor noticed that money-laundering investigations have a two-fold objective: to prevent the targets from profiting from the original crime and to prevent the targets from gaining enough clout to enjoy economic influence, which Grinda suggested sooner or later always reaches political power[19]. That is exactly the issue, which should be discussed first, when the threat Russian money poses to the West is taken into consideration. In 2017 the foreign affairs committee at the House of Commons of the United Kingdom in its report titled "Moscow's Gold: Russian Corruption in the UK"[20] accused its own country of turning a blind eye to Russia's "dirty money" and by that putting national security at risk. As it was mentioned above there is a good argument to take into consideration not just "dirty" or "dark" money in that context.

The more so, when the report itself refers almost to the same: "President Putin and his allies have been able to continue "business as usual" by hiding and laundering their corrupt assets in London. These assets, on which the Kremlin can call at any time, both directly and indirectly support President Putin's campaign to subvert the international rules-based system, undermine our allies, and erode the mutually-reinforcing international networks that support UK foreign policy". Jack Reed, a U.S. Senator from Rhode Island, one of his speeches on Russia's hybrid warfare operations against the West in the Senate in 2018 devoted entirely to Russian financial influence abroad[21]. In his speech he rightly pointed out to the *modus operandi* of Putin's system rather than to individuals just committing crimes.

The argument he made is worth quoting in full:

"The Russian system of corrupt financial influence rests on Putin's domestic power structure. The Putin regime is fundamentally a kleptocracy, which is a system where corrupt leaders use their power to exploit their country's people and natural resources in order to extend their personal wealth and personal power. Putin has systemically fostered kleptocratic conditions by exploiting state funds and resources to reward a group of close associates, commonly referred to as oligarchs. [...] In exchange for wealth, privilege, and often impunity, this group of Putin's cronies are readily deployed to act on behalf of Kremlin interests. [...] Russia's kleptocratic system reinforces Putin's power in several ways. First, he controls who profits from state coffers, making the recipients of state largess indebted to him. Second, he can outsource projects of financial influence, which provides him with access to private wealth streams and gives him plausible deniability if the projects have a nefarious aspect. Finally, this system allows Putin to ensnare oligarchs who may have enriched themselves through a corrupt deal or committed crimes that were state-sanctioned"[22].

All these conclusions have been drawn since at least 1999 and warning have been publicly made since then are not based on any personal assumptions. They belong to people who are not just simple researchers on Russian kleptocratic and mafia-type regime. These are conclusions, which have been drawn by officials from the security services, prosecutors' offices and members of parliaments of the democratic world and are based on crystal clear evidence. Nevertheless, it seems not much of that has been publicly accepted as a real threat definition and even less of lessons have been learned.

Dropping illusions

In order to drop some wide-spread illusions about Russian money flow, several arguments from the report "Moscow's Gold: Russian Corruption in the UK" are worth mentioning separately. The report comes almost to the same conclusion Senator Reed has come to: "There is a direct relationship between the oligarchs' wealth and the ability of President Putin to execute his aggressive foreign policy and domestic agenda. [...] You have to look at the Russian oligarchs as a class. No matter how different they seem to you – one owns a football club, another donated money to Oxford for a school of government, another sat in a Russian jail for six years under communism, another was a civil servant – they all have very particular things in common. [...] They are not self-made businessmen in the American sense. Every one of them made money through a relationship with the Russian Government. That bond forces them to do all sorts of chores for Putin, whether hidden, visible or invisible."[23]

These conclusions are fully supported by tons of public information on the Kremlin's attacks against the West. Putin's strategy to deploy his oligarchs can be examined in detail from the special counsel Robert Mueller's report on Russian interference in the U.S. presidential elections in 2016[24]. Take the episode of Russians offering illicit funding to Italian far-right party[25], infamous loan to French National Front[26], meddling in Montenegro elections[27] or any other Kremlin's attempt to exercise its influence in the West, an opaque network of high-level Russian political figures, businessmen and even spies can be traced.

Nevertheless a wide-spread illusion that Russian oligarchs and even Russian money should not be measured by one yardstick still prevails. When former Swedish foreign minister Carl Bildt, who has been a well-known Kremlin critic, accepted the offer to join Russian oligarchs owned LetterOne group as an adviser[28], numerous other Kremlin critics jumped not only to his defense, but to the defense of Russian oligarchs behind LetterOne as well[29]. The assumption was made that differentiation between Russian oligarchs and their readiness to serve the Kremlin interests is essential. On top of that a new image building campaign in order to whitewash Putin's kleptocracy[30] could have been noticed with the same oligarchs involved.

However, Mueller report shed a light on a role Putin assigned on Petr Aven, one of the owners of LetterOne, in the Kremlin's campaign to achieve its goals concerning president Trump. Though, he and the other LetterOne principals were noticeably absent from the list of Russians sanctioned by the U.S. Treasury on the grounds of election meddling, many questions on their other involvement has left unanswered[31]. While taking into consideration the threat of potential criminal activities Russian money flow brings with it, LetterOne owners have raised doubts about their *modus operandi* as well. Oligarchs mentioned have been grilled by Spain's top court over accusations that they used methods 'typically used by the Russian mafia' to devalue firm they sought to buy[32].

Since "Troika Laundromat" accusations were made public, another Russian oligarch Ruben Vardanyan has been cast in a new light[33]. Before the scandal he was mostly known as generous philanthropist in the West and "enjoyed a reputation as a Western-friendly representative of Russian capitalism". However, the scandal exposed not only an almost $ 9 billion alleged global money-laundering scheme, but one of Russian President Vladimir Putin's oldest friends, as one of the main beneficiaries of the scheme, as well[34].

Before Maria Butina, a Russian agent jailed for infiltrating the U.S. political groups[35], was publicly exposed, hardly few in the U.S. have heard about Konstantin Nikolaev. Though another Russian oligarch invested in the U.S. energy and technology companies[36], he kept a low profile and didn't draw attention to himself. After Butina was exposed, not only his financial support for Butina came into the spotlight, but his extensive connections to Russian security services were made public as well[37]. Despite all that a group of former advisors to Donald Trump's 2016 presidential campaign have accepted the offer to lobby on behalf of the gas company Nikolaev co-owns[38].

All that goes in line with the testimony Garry Kasparov, a prominent critic of Putin's regime, submitted to the House of Commons of the United Kingdom for the report titled "Moscow's Gold: Russian Corruption in the UK": "They are agents of a rogue Russian criminal regime, not businessmen. They are complicit in Putin's countless crimes. Their money is not truly theirs, it is Russia's. Their companies are not mere international corporations, but the means to launder money and spread corruption and influence"[39].

Some evidence suggests the same can be applied to oligarchs, who publicly pretend to distance themselves from Putin's regime and even hold passports of the Western countries. For example, Russian oligarch and former UK newspaper owner Alexander Lebedev responded angrily to media allegations that a British government report on Russian interference could contain damaging information about his relationship with Prime Minister Boris Johnson. Lebedev complained of feeling victimized in Britain after he "did the British people a service" by investing in the media. "I definitely felt more comfortable when I worked as a Soviet spy in England," he was quoted by AFP[40]. However, even if Lebedev doesn't work as a spy anymore, he has been caught trying to help Putin to win Western approval for the annexation of Crimea, as so called "Surkov leaks" revealed[41].

Evgeny Lebedev, the son of Alexander Lebedev and a personal friend of UK Prime Minister Boris Johnson complained that "Russophobia has infiltrated Britain" when information about his private party with Johnson was made public. He urged to judge him on what he has done for the country, and what he intends to continue to do, rather on the fact that he is Russian[42]. An appeal might sound plausible, however Evgeny Lebedev himself has been instrumental in promoting the Kremlin's foreign policy goals[43].

A major donor to the UK Conservative Party Alexander Temerko presents himself as a critic of Putin. However, he is not shy praising Russian security officials, including the current and former heads of the Federal Security Service (FSB). On top of that Leonid Nevzlin, one of Temerko's former business partners, confirmed to Reuters that Temerko had long-standing ties with Russian security agencies, though declined to say whether he believes those ties remain active[44].

The US politicians as well as Western think-tanks and universities cannot stop taking Len Blavatnik's money[45]. Blavatnik prefers to be called a global industrialist and philanthropist. He is always positioning himself as an outsider in Russia and a local in the West and makes all efforts to distance himself from Russian politics and, in particular, from Putin[46]. However, there is no secret that he made his billions together with such well connected to Kremlin oligarchs as Oleg Deripaska and Viktor Vekselberg. The latter tries to position himself being "pro-American" but has been under sanctions for suspected meddling in the 2016 U.S. election[47].

The strategy of capturing: from individuals to entire states

All mentioned is not just separate cases or any coincidences. That makes the Kremlin's strategy. In order to fully understand the toxicity of Russian money flow to the West, that strategy should be thoroughly examined. The Kremlin foreign policy advisor Sergey Karaganov, with characteristic cynical openness, describes Russian foreign policy as one that seeks to buy the elites of neighboring countries "with money that was then stolen, likely together."[48] These words form a compelling narrative illustrating how Russia exports kleptocracy and buys influence abroad. More than that, one could hardly find a more accurate description of Russia's "weaponization of kleptocracy" – albeit with one small correction: Russia has not been limiting itself merely to bribing the politicians of neighboring countries[49].

The strategy of such weaponization which ultimately can lead to the state capture, is analyzed in detail in two studies of the U.S. based Centre for Strategic and International studies: "The Kremlin Playbook: Understanding Russian Influence in Central and Eastern Europe" and "The Kremlin Playbook 2: Enablers". "The Kremlin Playbook: Understanding Russian Influence in Central and Eastern Europe" lays out the Kremlin's mechanism for exercising its influence abroad: "Russia has sought to maintain its influence by cultivating a network of local affiliates and power-brokers who are capable of advocating on Russia's behalf. These affiliates are often wealthy and influential businessmen or former high-ranking public officials who are able to influence decision-making. Typically, Russia entices these individuals into its service by offering them lucrative business opportunities, in which the Russian government is involved, and provides premium returns to its clients"[50].

According to the report, this is the way how Kremlin "captures" individuals in order to use them advancing Russia's interests politically and economically. It's not a surprise that such individuals, pursuing their own interests, are often the most vocal advocates of Russian-led projects. At the same time they are strongly opposed to efforts to diversify commerce away from Russia. "In this way, Russia appears to have created a mutually reinforcing network of patronage that rewards loyalty with loyalty—with increased financial compensation"[51], the report concludes. How effective such mechanism can be one can learn from the Latvian example. After Latvian law enforcement officials secretly taped conversations between three main Latvian oligarchs, they and later also the Latvian society learned not only that Putin, according to oligarchs view, "managed to bring order to Russia". One part of these conversations illustrates exactly the mechanism described by "Kremlin's playbook" in play. Namely, oligarchs discussed an option for one of Latvian politicians becoming a prime minister, because "Moscow thinks she would be a good candidate"[52]. It seems there is no need to mention, that the business of all three oligarchs is dependent on Russia.

The same opaque networks of Western politicians and businessmen related to Russia apparently had much to do with successful efforts to compromise Western sanctions policy. For example, a long-time associate of Putin from his KGB days, Vladimir Yakunin is under the U.S. sanctions for the involvement in Russia's annexation of Crimea. However, Yakunin managed to avoid European and Canadian sanctions. According to some reports, Yakunin was omitted from the European Union's blacklist after Latvia lobbied strongly to have his name removed[53].

Yakunin suggested himself that his close business relationships, notably with "Bombardier" chairman Pierre Beaudoin, may have helped to shield him from Canada's list[54]. "Bombardier" denies the claim. Though Yakunin is also a board member of the "Russkiy Mir" organization which plays a key-role in Russia's orchestrating Russian governmental influence abroad, he has been granted a visa to visit the EU Member States, was invited to speak at the EU-funded conference and even established a think-tank in Berlin[55].

It is obvious that Russian oligarchs have spent considerable resources trying to get their names removed from the U.S. Treasury Department's sanctions list, injecting foreign money into a vast complex of influence peddlers formally employed as lobbyists, lawyers, public relations consultants, private investigators, and other professional service providers[56].

Greg Barker, a member of Britain's House of Lords and the chairman of En+ Group Plc, was awarded a bonus of about 3 million to 4 million pounds for negotiating the removal of U.S. sanctions on the Russian company, according to Bloomberg report[57]. Lord Barker has a long history working for Russian oligarchs. As Bloomberg reports, a former associate partner at public relations firm Brunswick Group, he moved to Russia in the late 1990s to work for another oligarch: Roman Abramovich. Barker was hired as the head of one of divisions at Sibneft, Abramovich's oil company, around the same time that Abramovich was merging his aluminium assets with Deripaska to form Rusal. Two decades later, a recommendation from Abramovich's group helped persuade Deripaska to appoint Barker as a chairman of En+, according to a person familiar with the matter. He took the role in October 2017, just a few weeks before the company floated in London[58].

To put it into context, according to press reports, Deripaska for quite a long period of time has been denied even the U.S. visa over alleged criminal connections[59]. In 2018 Switzerland denied Abramovich residency over suspected criminality[60]. In the study titled "The Kremlin Playbook 2: Enablers" authors directly address the problem of Russian money flow to the West: "Every year, billions in investment and profits move in and out of European countries through the enablers' financial systems. These financial systems offer specific tools that are designed to obscure the origins of certain investments and conceal illicit financing. It has become almost impossible to disentangle Russian capital outflows from other financial flows, including for the most capable oversight bodies in the world. Russian private holdings abroad total an estimated $ 1 trillion"[61].

Authors of the report point out to the additional problem, which is related to these significant capital flows. They draw attention to the risk of damaging national security "by corrupting government officials who can alter policies, impeding the free flow of capital, reducing the efficacy of sanctions regimes, and distorting entire markets and industries"[62].

For example, according to French senators, France's national interests and President Emanuel Macron's security had been put at risk[63]when Macron's personal security advisor Alexandre Benalla had been selling protection services to another Russian billionaire Isklander Makhmudov. The latter is suspected of ties to Russian organized crime as well[64].

Weaponized "business" deals and charity

Over the past decades money laundering has become to seem an indispensable part of Russian money flow to the West. But only over the past years the number of European banks involved[65] points to snow-ball effect of the problem, which has been more or less neglected for years. On top of that, experts have started to discuss Russian money laundering in the context of the dark art of it reaching new and innovative heights. An analysis of major Russian money-laundering scandals exposed in the last decade reveals four new particularly sophisticated techniques[66].Besides, Russian money laundering doesn't limit itself to the banking sector. "Dark" money, which needs to be laundered goes into big, anonymous real estate deals in the United Kingdom,[67] Germany[68] and other countries. American real estate became a "giant magnet" for Russia's kleptocratic fortunes after lobbyists pushed to allow anonymous shell companies to buy properties[69]. In such a context not only experts have started to discuss a phenomenon of weaponized finance interfering[70] , but the Baltic states bankers have coined a term "weaponized financial crime". Russian investments into football clubs have come under scrutiny after at least two cases of money laundering through such investments were exposed in Europe[71].

Finland has been forced to introduce a new law for foreigners buying property in the country. It will require from foreign buyers of Finish real estate to seek permission from the country's Ministry of Defense. The law was introduced amid concerns that hostile intelligence agencies might use investments for the hostile actions against the county. The Finnish Ministry of Defense insists that the new laws are "not directed to any specific country or actor(s)." However, concerns about the intentions of foreign investors were raised last year, when Finnish officials mounted a huge military style raid on properties linked to a Russian businessman called Pavel Melnikov. Hundreds of officers backed by helicopters, a surveillance plane and a no-fly zone stormed 17 separate properties owned by Melnikov's tourism company. Police said the raids were connected to allegations of financial crimes, but they sparked speculation that authorities were also concerned that the properties could have been used for spying[72].

The comprehensive report on the Kremlin's propaganda-related institutions and their connections with Western and Russian academia was released in 2019. The report is titled "Hybrid Analytica: Pro-Kremlin Expert Propaganda in Moscow, Europe and the U.S. A Case Study on Think Tanks and Universities" The key conclusion authors of the report make is that the current Russian government pursues a coherent "knowledge weaponization" strategy, including through Kremlin-related oligarch donations to Western institutions[73].

Conclusion

All mentioned taken into account, the answer to the question "how toxic Russian money flow is" seems to be crystal clear. Putin's regime and its cronies, who own Russia's wealth, have blurred lines between legitimate economic activity, corruption and other financial crimes, between cooperation and malign influence, between economy and weapons in a war the Kremlin wages against the West. As

Mark Galeotti puts it, "in 1994, Russian President Boris Yeltsin warned that his country was becoming "a superpower of crime." Today, Vladimir Putin appears to be courting that very same status, but in a profoundly different way, regarding Russian-based organized crime abroad not as a threat or embarrassment, but a potential opportunity. As Russia's geopolitical competition with the West continues, understanding the nature of this threat will be increasingly important for European security"[74].

However Galeotti refers only to pure criminal activities related to the regime. In view of the author of this article the same should be applied to almost everything that is related to Russian kleptocracy and money flow to the West. Insofar as the West continues to consider Kremlin-led mafia state "open for business" it will be easy for Putin to pursue its goals by means of corruption. As Ben Judah and Nate Sibley advocate it, instead of viewing the problem "merely as the actions of bad actors, in bad countries, seeking bad people to bribe in the West, Western powers need to develop a national security strategy that recognizes economic crime as a systemic threat to democracy and security worldwide. But first they need to define it clearly—and explain to the public why it matters[75].

Democracies can't be overtaken by kleptocracy, which always comes along with autocracy, as long as citizens trust their democratic institutions and the functioning of the system as such. Therefore, Putin's kleptocracy, which could not otherwise hope to compete with democratic, free market system, hopes to infect Western countries with its own kleptocratic virus, refashioning them in Russia's image. Any failure to push back against kleptocracy, which comes with Russian money flow, stipulates further attacks on democracy, the erosion of the rule of law and market economy. By that, threats to national security and vulnerability of the West in the hybrid war Russia wages against it further escalates and the risk of a snowball effect increases.

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Russia's Economic Narratives Towards the Baltic States: Structural Elements and the Potential of Ideological Alignment

Mārtiņš Kaprāns

Economic narratives have not always been at the frontline of Russia's disinformation strategy towards the Baltic states. In the 2000s, they were overshadowed by the narratives of historical revisionism and violation of the Russian-speakers' rights. Then, disinformation was primarily focused on strengthening the Russian-speakers' diasporic identity and undermining the international image of the Baltic states. However, the salience of economic topics has significantly increased since global financial crises (2008–2010) that hit hard Latvia, Lithuania, and Estonia.

Ever since the global financial crises and economic recession Baltic countries have experienced a rapid recovery. Along with a persistently rising GDP and salaries and declining unemployment rates, they have been among the fastest growing economies in the European Union. Although the growth might slow down and stabilize, it is expected that Baltic economies will continue growing in the next years to come[1]. The remarkable performance of Baltic economies, among other factors, can be attributed to the growing manufacturing industry, transport services and telecommunication, computer and IT services. It should be also added that Latvia, Lithuania, and Estonia have been consistently rated as top countries for the ease of doing business by the World Bank (19th, 14th and 16th respectively out of 190, as of 2018)[2]. Contrary to this optimistic economic outline, the Baltic states have faced with crucial socio-demographic challenges (e.g. emigration, aging society, labor shortage, income inequality) that may constrain the economic development in a long-run perspective and increase anxiety in Baltic societies. Such reverse conditions where objective economic growth contrasts with detrimental social changes and people's subjectivities therein set the stage for Russia's contemporary narratives towards Baltic economies.

The goal of this chapter is to explore the basic elements of Russia's current economic narratives towards the Baltic states and to examine their potential to align with the public opinion of Baltic societies. This analysis is based on secondary sources that have produced a valuable analytical material on Russian disinformation activities undertaken within the last five years (cf. EU vs. Disinfo, Digital Forensic Research Lab, CEPA Stratcom Program). Likewise, the chapter explores cross-national sociological data from the public opinion survey "Ideological polarization in Baltic societies" conducted in 2019.

The grammar of parallel economic reality

Russia's economic narratives towards the Baltic states (henceforth called the pro-Kremlin economic narratives) operate on two levels. Firstly, Baltic countries are addressed as a uniform region, *Pribaltika*. The *Pribaltika* region in the Russian media parlance evokes associations with a Russian/Soviet geopolitical understanding of Baltic countries as not being sovereign political entities. Secondly, economic narratives construct a distorted image of a single country that is occasionally used to symbolize all Baltic countries. In both cases the pro-Kremlin economic narratives have the same purpose: to undermine Baltic economies and their advancements since the collapse of the Soviet Union.

The claim that Baltic countries do not have a viable economy provides a template for Russia's economic narratives. Pro-Kremlin media usually juxtapose this formative statement to the popular Soviet-era brands and products that the Baltic Republics produced during the Soviet period, making them famous in the whole USSR. Today, it is argued, the Soviet-era factories are dismantled, driving Baltic countries to depopulation, poverty, high unemployment and weak economies. In particular, such economic narratives point out a high emigration rate from Baltic countries to Western Europe, implying that Baltic nations will cease to exist in a foreseeable future and will be replaced by people from other cultures[3].

Along with self-styled experts on the Baltic states, prominent Russian politicians are regular sources of various apocalyptic statements. That clearly demonstrates the strategic character of the above-mentioned narrative template. The mythology of a successfully functioning Soviet economy in general and of specific industries in particular primes the post-Soviet accomplishments of the Baltic states. Arguably, Latvia is most often used as a showcase of the imagined post-Soviet economic devastation, misleadingly claiming that "no serious manufacturing has remained in Latvia"[4] or "the population has declined by 50 percent since 1990"[5], or "the country's budget is hardly sticking together"[6]. Such priming, of course, ignores any economic successes and overlooks the fact that the economic situation and conditions for market economy in three Baltic countries are much better than in Russia; per-capita GDP, average salaries and pensions are all much higher than in any of the other 12 ex-Soviet republics.

Beyond the glorification of the Soviet-era economy, pro-Kremlin media primarily interpret the unsustainability of Baltic economies as an outcome of unfriendly attitude towards Russia or *Russophobia* that has emerged after the collapse of the USSR. This subtly broadens the scope of economic narratives to non-economic realms. Specifically, it is insisted that the allegedly discriminatory attitude towards Russian-speakers, wrong understanding of history (e.g., WWII, the Soviet period), and international criticism of Russia's policy towards other countries (Georgia, Ukraine) have damaged pragmatic and mutually beneficial economic relations with Russia. In order to emphasize the destructive economic consequences of bad relations with Russia, pro-Kremlin narratives tend to exaggerate the role of the Russian cargo transit in Baltic countries, presenting it as the last economic branch that "made these countries important"[7]. This helps to create a parallel reality in which the impact of Russia's decision to reduce the cargo transit through Baltic ports is presented in fatalistic terms.

The dependence of Baltic economies on good relations with Russia was particularly highlighted after the introduction of EU sanctions in 2014. While pro-Kremlin media framed the so-called Western sanctions as a non-problem for Russia[8], they produced many dramatic stories about the devastating impact of Russia's countersanctions on Baltic economies. Reports on shrinking cargo transit as frequently presented in conjunction with selective and hyperbolic stories on how the Russian countersanctions decrease the intensity of production in some industries or how the number of Russian tourists in the Baltic states is in decline[9]. Such stories, among other goals, intend to foster support for lifting EU sanctions. As a matter of fact, the pro-Kremlin media accounts ignore the actual irrelevant effect of Russia's countersanction on the GDP of Baltic countries; they are also silent about the volatility of Ruble and the general unpredictability of Russian market as crucial factors that may have objectively worsened economic relations with the Baltic states during the first years of Western sanctions.

With the introduction of sanction after the annexation of Crimea Russia's criticism of the EU has become more explicit and ardent. In this respect, two different storylines are fostered in Russia's economic narratives towards the Baltic states. The first storyline frames the EU as an exploiter who sees the Baltic states as only a market for their goods and a source of cheap labor. Therefore, pro-Kremlin media argue, the EU on behalf of Germany, France and other powerful member states are not interested in supporting the actual development of Baltic economies. Instead, it wants to eliminate industries in the Baltics thus reducing competition[10]. To be sure, the *exploitation frame* is embedded in a more general meaning-making framework that interprets the Baltic states as failed and provincial economies whose labor keeps migrating to other EU countries. The second storyline presents Baltic countries as totally dependent on EU money. Pro-Kremlin media insist that Baltic countries can only relay on the EU financial support as they do not have viable economies[11]. This *financial dependency frame* again shall lead to conclusion about the appalling prospects for the Baltic states which will cease to exist when EU money is over. It should be noted here that the share of financial support from the EU structural funds makes just a few percent in the GDP of the Baltic states.

Pro-Kremlin media exploit similar economy-based framing to explain the role of NATO in the Baltics. This has been of particular importance after the deployment of NATO multinational battle groups in Poland and the Baltic states. The pro-Kremlin disinformation ecosystem has framed the 2016 deployment of NATO battle groups as a manifestation of hidden business interests of larger NATO countries (e.g. US, UK) to obtain control over Baltic resources or to sell outworn weapons[12]. The association of the NATO and also EU activities with the hidden economic interests of some superior powers echoes with Watanabe's conclusion about the Sputnik News articles where conspiracy frames are more likely to be used in articles about economy and politics[13]. Another narrative thread as regards NATO insists that Baltic countries support the deployment of NATO forces in their territories because that provides new job opportunities to local people and gives chances to new businesses[14]. As a result, this *it's-all-about-business frame* endorses a demoralizing explanation that Baltic countries welcome the NATO multinational battle groups merely out of economic interests rather than profound security considerations.

In a nutshell, the EU and NATO function as proxies in the pro-Kremlin economic narratives that help to illustrate and contextualize the economic devastation in the Baltic states. The excerpt from Russia's one of the leading state-controlled TV channels, NTV, is a case in point to demonstrate the nexus between these proxies and the main narrative template:

"The Baltic states [*Pribaltika*] are now one of the most backward economic regions in Europe, mainly supported by subsidies from Brussels. Back in 2004, for the sake of joining the European Union, virtually all industries were shut down in Baltic countries, manufacturing plants and factories were closed to meet the requirements of the EU. [...] Even the successful agriculture of the Baltic states was, so to say, forced out. [..] Highly qualified Balts with brains and hands are leaving not just for work, but for permanent residence […] Villages are empty, farms disappear, cities lose their status and turn into villages, but this half-empty territory is seen as a good training ground for NATO. Politicians are not ashamed of this. Let it be so, they say, as this gives money in return. [..] Some Baltic politicians even call for the activation of NATO forces [...] in order to receive another funding."[15]

Apart from the structural elements of pro-Kremlin economic narratives, it is important to take into consideration more conditional disinformation activities. That is to say, specific economic projects that have strategic relevance across the Baltic states are also the targets of disinformation. The pro-Kremlin economic narratives have specifically addressed Baltic energy policies over the last decade.

Not only do these narratives remind that Russia is the main energy provider in the Baltics, they also contest the opposition of Baltic countries to the *Nord stream 2* project, a project of a new gas pipeline that crosses the Baltic Sea[16]. Likewise, pro-Kremlin media have sought to delegitimize the ideas of Baltic energy independence and Baltic solidarity in terms of the Ostrovets nuclear power plant that Belarus and Russia have jointly built at the Lithuanian border[17].

Another specific economic initiative that pro-Kremlin media have been focusing on is *Rail Baltica*, a rail transport infrastructure project with a goal to integrate the Baltic states in the European rail network. This project has caused noticeable controversies in and between Baltic countries. Pro-Kremlin media have tried to downplay the economic dimension of these discussions. Instead they have sought to militarize this project by pushing forward a narrative that *Rail Baltica* is a measure to build up the NATO military infrastructure[18]. Likewise, they have fostered a claim that the Baltic states do not have enough money to implement this project, therefore *Rail Baltica* is "permanently "frozen"[19].

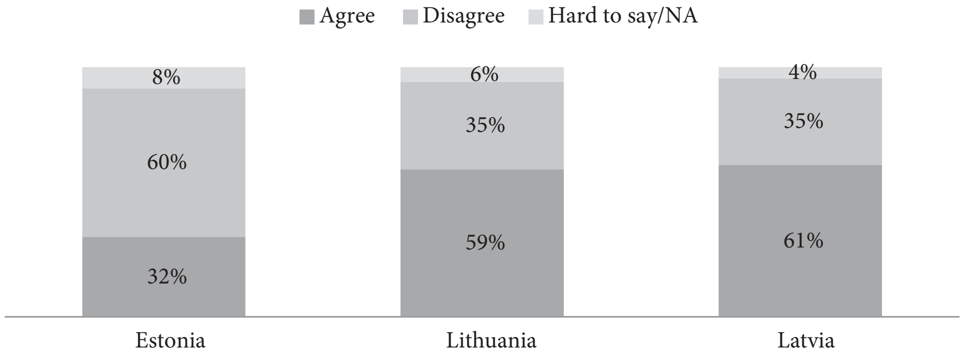
This outline of the structural elements of economic narrative suggests that pro-Kremlin disinformation ecosystem uses economic context in order to address the actually existing social vulnerabilities of Baltic societies, such as depopulation, emigration, and social inequality. In additions, the myths of 'the lost Paradise' (the Soviet-era extensive industrial policy) and 'apocalypses now' (the reality of market economy) are used to contest the Baltic success story. Framing Baltic countries as failed states rather than the most successful ex-Soviet republics is the way how Russia attempts to impose its post-Soviet transformation as a role model.

Aligning with opinion groups in the Baltics

In order to understand to what extent public opinion in Baltic countries might align with the pro-Kremlin economic narratives, this section examines the 2019 data from a fully representative cross-national survey "Ideological polarization in Baltic societies"[20]. These data give an insight into the size and profile of opinion groups that are more likely to accept the pro-Kremlin economic narratives.

According to the survey data, the core claim of Russia's economic narratives that the Baltic states do not have viable economies elicit significant differences between the Baltic societies (Graph 1). That is, Estonians demonstrate a moderately strong opposition to the statement that the economy of their country is underdeveloped and cannot ensure the sufficient and long-term development. The majority of Lithuanians and Latvians, in turn, agree upon a negative assessment of their state's economy. Incidentally, the Eurobarometer cross-sectional data confirm such differences, showing that Estonians have a significantly more positive opinion about their country's economic situation than Latvians and Lithuanians[21]. Hence, Latvian and Lithuanian public opinion is relatively more likely to align with the narrative template of Russia's economic narratives.

Graph 1: The economy of my country is underdeveloped and cannot ensure sufficient and long-term development*

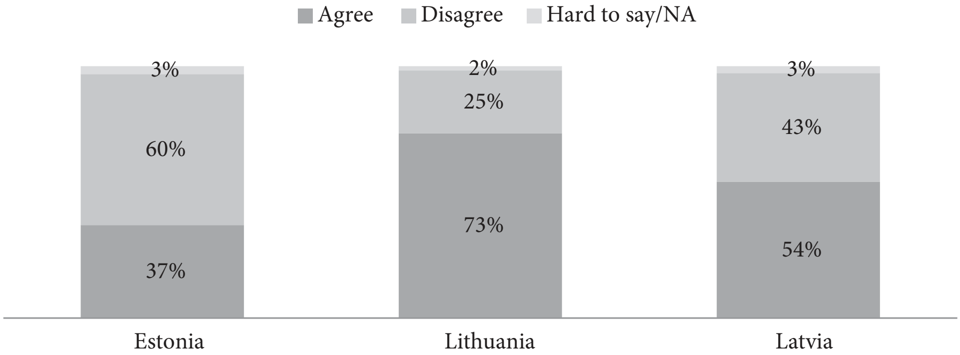


Note: all graphs in this section present the data from a reduced scale. Originally, the survey items were measured by Likert scale (Completely agree, Tend to agree, Tend to disagree, Completely disagree)

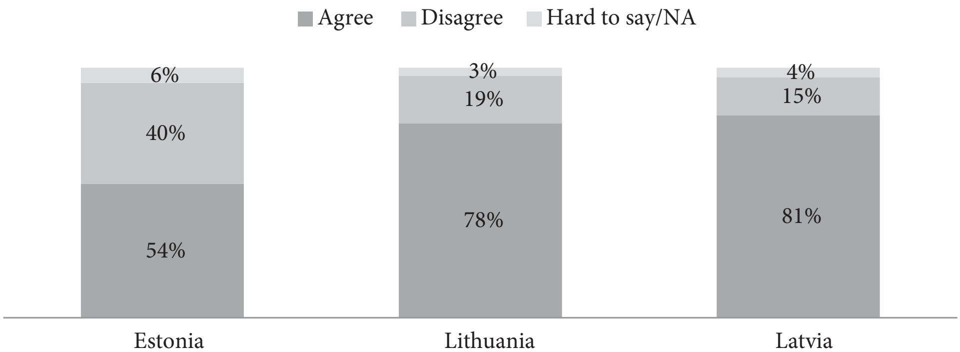
Social inequality is a specific dimension of Russia's economic narratives that shall reinforce the image of failed Baltic economies. In the 2019 survey, Baltic respondents were asked to express their attitude towards the statement that poverty and unemployment prevails in their countries. The survey results yields a complex picture (Graph 2). While Estonians hold a moderate consensus that poverty and unemployment do not dominate in their country, Lithuanians hold a strong consensus that they do. In comparison with other Baltic states, Latvian public opinion is divided into two equally large opinion groups: those who support and who do not support the poverty and unemployment claim.

Emigration, as I have argued in the previous section, is often emphasized in the pro-Kremlin economic narratives as a tangible evidence of dysfunctional Baltic economies. The 2019 survey measured the attitude of Baltic societies towards the statement that every day many residents leave their country and do not want to live there. The data demonstrate a very strong consensus among Latvians and Lithuanians toward accepting this claim (Graph 3). Conversely, a situation in Estonian public opinion is highly polarized between supporters and opponents of such a claim. Although recent migration statistics suggest that the pace of emigration has slowed down in Lithuania and Latvia, the society's formative experience of high emigration during the economic recession (2008–2011) most likely still retains strong support for the narrative that many residents do not want to live in their countries. Perhaps findings from Estonia goes in line with the fact that emigration in this country has been significantly smaller, thus giving limited space for 'the everyone-is-leaving' claim.

Graph 2: Poverty and unemployment prevails in my country



Graph 3: Every day many residents leave my country and do not want to live here (2019)

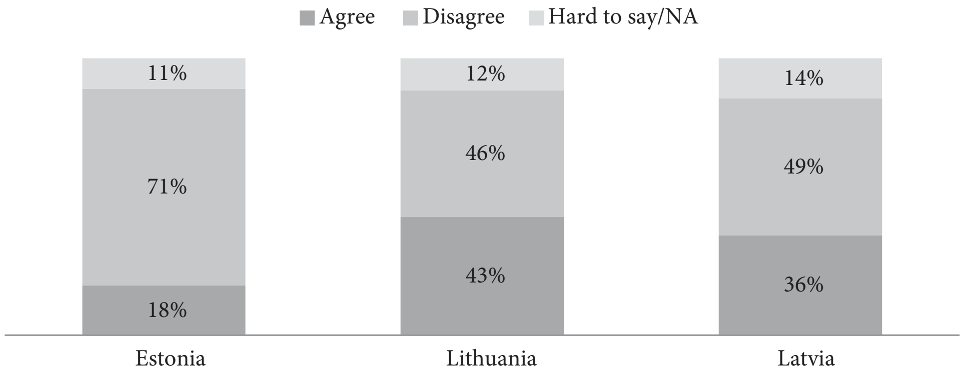


In light of demographic prospects that are systematically elicited in Russia's economic narratives, Baltic respondents were also asked for opinion about the more general apocalyptic statement that the people of their country is on the edge of extinction and will cease to exist in 100 years. Identical or similar statement can be noticed in the pro-Kremlin economic narratives. The country-level data again reveal significant differences between Baltic societies (Griaph 4). While Estonians hold the strongest consensus that they are not on the edge of extinction as the nation, Lithuanians and Latvians demonstrate much weaker agreement. This shows that insecurity on the basis of national and cultural sustainability is more salient in Latvia and Lithuania than in Estonia. The pessimistic mood of

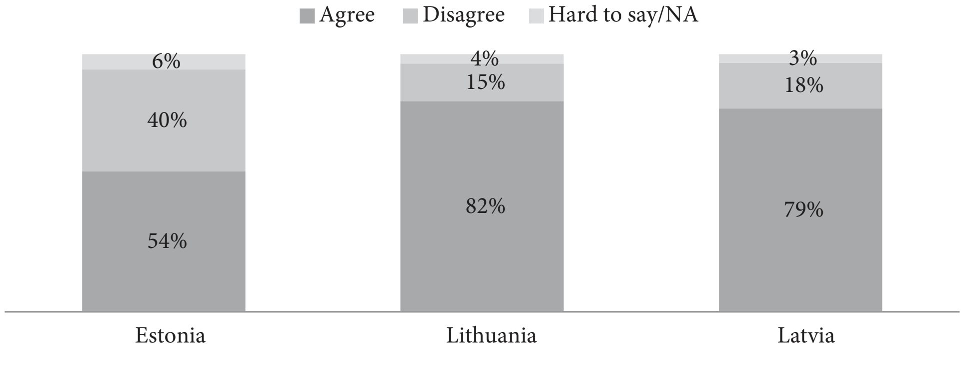
Lithuanians and Latvians can be partly explained by more negative demographic trends that have marked the last 15 years or so. In contrast, the demographic situation in Estonia has stabilized, if not improved over the last decade[22].

An opinion about the statement that the existence of one's country depends on the EU financial assistance alludes to what extent Baltic societies could align with the financial dependency frame in the pro-Kremlin economic narratives. The 2019 data indicate that Lithuanians and Latvians hold a strong consensus that their countries existence depends on EU financial support (Graph 5). In Estonia, this attitude also prevails, but consensus is much weaker, as a sizable opinion group support the belief that Estonia's existence does not rest on the EU's money. Overall, these data illustrate a diverse perception of the country's economic autonomy across the Baltic societies. While the dependency narrative is more common in Latvian and Lithuanian public opinion, the economic self-sufficiency narrative is more pronounced in Estonia. Regardless of these results, it should be added that the Baltic states are among the member states where the negative image of the EU is the least supported[23].

Graph 4: The people of my country is on the edge of extinction and will cease to exist in 100 years

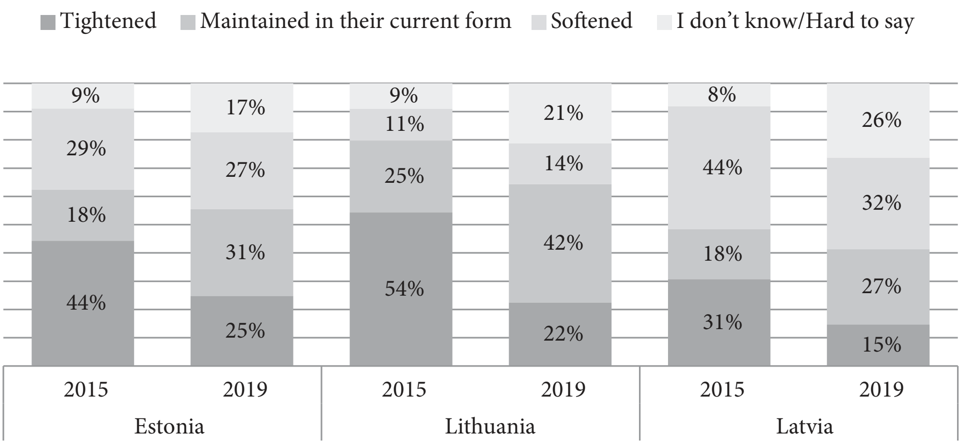


Graph 5: My country's existence depends on the EU financial assistance (2019)



Regarding the EU sanctions, the 2019 aggregate data reveal a rather pluralistic attitude in Baltic societies. The country-level data (Graph 6) reveal that Latvians are the least likely to support either the tightening of sanctions or the maintaining of the status quo, but are more likely to support the softening of sanctions or to express uncertainty with respect to this issue. On the contrary, Estonians demonstrate significantly higher support for the tightening of EU sanctions on Russia. Lithuanians, in turn, are more likely to maintain the current form of sanctions, and they are also the least likely to support the idea that sanctions should be softened. Hence, public opinion in each Baltic country takes a different stance on the EU sanctions on Russia. Overall though, support to sanctions is more pronounced in Lithuania and Estonia. The findings do suggest that narratives against sanctions have somewhat limited chances to find backing in the Baltic societies. Arguably, Russia's attempts to frighten the Baltic states with the destructive effects of countersanctions have largely not worked. Although geopolitically many Baltic respondents who believe that sanctions should be softened demonstrate a profound anti-Western orientation, it is remarkable that 53% of this opinion group think that their country should still work closely with the US and other Western powers. Perhaps this alludes to the syncretic and multi-layered nature of their geopolitical imagination.

Graph 6: The current sanctions against Russia by the EU should be:



The cross-sectional analysis indicates that support for the tightening of EU sanctions has deteriorated in all three Baltic states since 2015, particularly in Lithuania and Estonia where support has fallen by 22 pp and 20 pp, respectively (Graph 6). These changes, however, have reinforced support to maintain the current sanctions rather than to revise and soften them. Therefore the most significant increase in support for maintaining the status quo can be observed in

Lithuania (17 pp) and Estonia (12 pp). Notably, Latvian public opinion, unlike public opinion in other Baltic countries demonstrates a significant decline in support for the softening of sanctions on Russia (11 pp). This shows that the sanctions have been normalized by Latvian public opinion in particular and by the Baltic societies in general. It should be also mentioned that according to the 2019 survey data Baltic respondents who see Russia as a military threat are more likely to support Western sanctions. Although this relationship has weakened since 2015, it remains relatively strong, showing that insecurity, even if today less salient than during the escalation of the Russia-Ukraine conflict, is still a relevant motif for why the sanctions against Russia hold rather strong support in all Baltic societies.

A broader look at the 2019 survey results demonstrates that the vast majority of Baltic respondents who believe their country cannot exist as an independent state also support the pro-Kremlin economic claims that are reflected by the above-mentioned survey items. On the one hand, these generic doubts about the state's viability can be interpreted as a discontent that is rooted in specific socio-economic issues (e.g. poverty, depopulation, country's financial dependence). Namely, people are inclined to generalize their specific disappointment. On the other hand, the equally strong discontent with the state's performance that intertwines specific fields may allude to an opinion group that is by nature sceptical about the current state as such, including its economy.

According to the 2019 survey, the national pride variable on the aggregate level indicates another conspicuous fault line between those who strongly feel proud to be the citizens of their country and those who express no pride at all (a relatively smaller group). While the former disagree with the failed economy claims, the latter accept them. Moreover, the aggregate data suggest that those who distance themselves from political discourse in media as well as in private communication with friends are more likely to accept these claims. However, the differentiating role of political alienation is less pronounced in Latvia where people who, judging from their self-assessment, are actively engaged in political discourse also demonstrate a rather high likelihood to support the pro-Russian economic narratives. Last, but not least, one's satisfaction with life may provide one more significant explanatory angle. Generally speaking, data show that people who are more satisfied with their lives are more likely to disagree with the pro-Kremlin economic narratives.

The socio-demographic analysis reveals somewhat inconsistent and country-specific patterns. The most consistent pattern can be observed in terms of education. That is, the less educated segments of Baltic societies are more likely to support the pro-Kremlin economic claims. Household incomes are also a relevant factor that helps to understand the susceptibility to the pro-Kremlin narratives. According to the 2019 findings, the wealthiest residents of Baltic countries are less likely to agree that their country's economy is underdeveloped and cannot ensure a sufficient and long-term development, or that poverty and unemployment prevails in their country or that every day many residents leave their country and do not want to live there. Notably, various age groups and thus various generations largely do not indicate significant differences with respect to the pro-Kremlin economic narratives.

Public opinion in Latvia and Estonia is significantly differentiated also along the ethno-linguistic lines, as the Russian-speaking segment is more likely to support the pro-Kremlin economic narratives. As a matter of fact, the regional factor provides more consistent results across the Baltic societies, but here one should take into account the underlying ethnic differences in Latvian and Estonian regions. The data show that almost all survey items, explored in this section, trigger regionally diverse reactions. In Latvia and Estonia, the pro-Kremlin economic narratives are more often accepted in Russophone regions or counties (the Latgale region and the Harju and Ida-Viru Counties). Nevertheless, some less Russophone areas have also contributed to generating significant differences, such as the Zemgale region in central Latvia and Hiiu County in Estonia. This suggests that regional differences have not only ethno-linguistic, but perhaps also a socio-economic character. Moreover, the Estonian and Latvian data show that the failed economy claim is more often supported outside capitals or other big cities. Lithuanian public opinion approves such asymmetry, indicating that people who live in less populated areas (towns, villages) are more likely to accept pro-Kremlin claims. In particular, the residents of Western Lithuania (Telsai, Taurage, Marijampole Counties) are more likely to agree with such claims.

Conclusion

In this chapter, I have sought to outline the building blocks of the pro-Kremlin economic narratives towards the Baltic states. Manifold as they may be, these narratives strictly follow to the Kremlin's strategic logic: to create and maintain a negative image of Baltic economies. To be sure, this undermines the Baltic success story of transition from the Soviet economy to market economy that in the West is often juxtaposed to failures in other former Soviet republics, including Russia. The economic narratives disseminated by the pro-Kremlin disinformation system particularly address the issues of demography and income inequality in Baltic countries, presenting them as the tangible outcomes of dysfunctional economies. However, these narratives do not primarily target the Baltic states as such, but rather their political elites that have, allegedly, taken wrong geopolitical decisions by joining the EU and NATO and by internationally criticizing Russia. In short, the pro-Kremlin economic narratives have more to do with geopolitics than with the actual economic reality in the Baltics. In this respect, these narratives construct an alternative reality.

The pro-Kremlin economic narratives, no doubt, can gain from the existential anxiety and anti-establishment sentiment that are nurtured by the demographic problems of Baltic societies. These problems have set the scene for ideological parallelism, the conditions in which the pro-Kremlin socio-economic claims should not necessarily define the alternative reality, as it is in the case of defending Russian-speakers in the Baltics. Instead, they should merely nudge the present and highly sensitive social issues that are already invoked by local incumbent (not necessarily pro-Kremlin) political actors. Such nudging, as Wilson has argued, is one of the basic types of Russian propaganda that affects and strengthens opinions which already exist[24].

The analysis of survey data in this chapter suggests that nationally alienated, politically (self-)isolated, and territorially/ethno-culturally marginalized individuals who are disappointed with their life trajectories and socioeconomic status form the most vulnerable segment of Baltic societies in terms of the pro-Kremlin economic narratives. In other words, the ethos of the failed Baltic economies is more likely to align with the socio-economically anxious and left behind individuals. Such a permanent resentment towards a state and anti-establishment feelings define the political identity of a considerable, but not dominant segment of Baltic societies. In light of this segment, the survey data, however, suggest that Latvian and Lithuanian societies might be more vulnerable vis-à-vis the pro-Kremlin economic narratives than Estonian society.

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[19] Ibid.

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Conclusion

Andis Kudors, Jānis Hermanis

The Russian political model assumes that the interests of the state are defined by the needs of a narrow elite, which also plays a key role in the national economy. The task of the political system is to protect and reproduce the long-term existence of this elite, so that the welfare of the state is only an instrument to maintain the power in the hands of the rulers. State institutes do not fulfill their direct functions; the country is run using unwritten laws and informal agreements instead. The existing facility is characterized by a high level of corruption, which leads to increased costs for society. Public administration tends to be associated with organized crime. National security services are used to protect the interests of the elite. Over the longer term, the share of state influence in the Russian economy has also increased, forcing out private companies. Russia is characterized by legal nihilism that ignores property rights and commits economic crimes, which do not make it attractive to foreign investment. The existing system does not allow for economic modernization, which would also require political modernization, not envisaged in the constitutional changes announced in early 2020.

Russia's current power elite's positions are closely related to the energy sector, because it has provided easy profits and serves as a source of significant financial volume for various political projects. The elite have no incentive to think about economic innovation and 'technological breakthrough' declared by Russian propagandists before the 2018 presidential elections. However, nothing is forever and global trends indicate that future demand for fossil fuels will undergo irreversible changes, and the question is no longer 'whether' but 'when' the fossil energy era will end. The driving forces behind these changes are the increasing development of new energy sources and the growing demand for greener technologies. The most appropriate solution to break the dependence on fossil energy revenues would be to diversify the economy by developing other sectors. However, Russian authorities will not pick up with real diversification "until the horse is stolen." The Putin's power system itself does not allow changes, which would create a culture of entrepreneurship promoting private initiative, foreign investment, innovation, fair competition, etc.

Energy exports provide 42 percent of Russia's budget and help build up savings in the National Welfare Fund. Russia has taken a dominant position in the European Union among other suppliers; it also seeks to exploit its dominant position in the political sphere; how can you otherwise explain the attempt to restrict free trade by the application of different pricing policies to different countries. Since the annexation of the Crimea and the war in Ukraine, the geopolitical situation in the region has changed dramatically, with the EU seeking ways to diversify energy supplies and improve security of supplies. At the political level, the EU is also committed to actively moving towards more climate friendly energy. Several EU countries have invested in infrastructure projects using alternative forms of energy, such as liquefied gas, and suppliers, leading them either to restrict energy imports from Russia or to force Russia to supply at lower prices.

Military spending has been a very important item in Russia's federal budget in recent years. The equipment and military capabilities of the Russian army have been significantly improved as a result of the arms program implemented in recent years. The contents of military expenditures are hidden from the general public with the status of secrecy. With the lack of transparency, the Kremlin itself has lost control of how this money is spent, as military equipment manufacturers are delaying deliveries and make them in a smaller extent than initially anticipated at inflated prices, with administrative machinery bloating around manufacturers. Against this background, there are many cases of corruption that have resulted in massive thefts. Part of the military expenditure is spent on the production of old-fashioned combat equipment. The lack of competition between companies, which usually have a monopoly in their field, also limits the effectiveness of the military sector. Russian military industry limits the living standards of the people, because education and health care are not sufficiently funded. Russian military companies should operate in conditions of greater competition, which would lead to more efficient and successful modernization of the armament and military equipment in the future, but Putin's system does not foresee such a scenario of promoting competition.

How has the progress of Russian farming developed during Putin's reign? Regional policy has not been consistent and efficient enough – it is mostly directed to the concentration of resources in the center, thus ensuring the Kremlin's control and power. Some attention has been paid to the regions, but only for selected periods, to prevent total degradation of peripheral areas. Russia has had a negative experience of economic centralization since Soviet times. The main drivers of centralization in Russia have usually been linked to the desire of the authorities to concentrate their resources on militarization, aggressive foreign policy and the consolidation of their ideology. At the same time, it is accompanied by the elite's fear of losing control over peripheral territories and the desire of the administrative apparatus to retain its influence.

Centralized economic policy has led to a dramatic difference in living standards between regions of Russia, with Moscow, St. Petersburg and those richest in natural resources (Tyumen and Sverdlovsk areas), on the one hand, and the rest of the territory on the other, especially the ethnic republics. The viability of deprived areas becomes dependent on Kremlin subsidies, as they are often deeply indebted and unable to switch to permanent economic activity. Their local administration is not intrinsically interested in addressing its own backwardness and improving the quality of life of its citizens, since it is comfortable with the current situation where it is possible to redistribute central funding without specific reporting on the efficiency of its use. As a result, a breeding ground for corruption is created (which will be not properly eradicated if the local authority is loyal to the Center), but all the burden of backwardness must be borne by the local community. If the inhabitants of these regions want to improve their living conditions, then all they have to do is go to a big city or immigrate to Western Europe.

Existing Kremlin policies provide limited subsidies to the poorest regions of Russia, which allow them to exist, but exclude the possibility of development to get rid of their backwardness. From the point of view of the existing Russian authorities, such a model is convenient because the poor regions are easily manipulated and retain their political loyalty. However, in the long run, the consequences can be dangerous and unpredictable, especially if Russia starts to lose its export earnings rapidly. In such circumstances, the level of aggression, conflicts between different ethnic and religious groups, etc. will increase, which may lead to the partition of Russia's territory.

Russia's aggression against Ukraine in 2014 led to EU and US sanctions against Russian officials and companies, which was one of the reasons for faster rapprochement between Moscow and Beijing. Russia needed to show that it was not 'hurt' by sanctions because there was an alternative – economic cooperation with China. If China was once economically dependent on Russia's predecessor – the USSR, which was then one of the two world powers, today it is the other way around. It is obvious that in this relationship, the oldest brother is China and the youngest is Russia, and such division of roles will continue. Russia is showing unprecedented benevolence against China in the form of access to strategic areas, including military technology and the energy sector. However, this cooperation is unable to maximize the interests of Russia, for example, a recently signed long-term contract provides for gas sales to China cheaper than the market price. Despite special favors, the Chinese investors do not view the Russian market interesting enough with other alternatives in the background. Active cooperation mainly takes place in large-scale investment projects carried out under the supervision of senior officials of both countries. Average Chinese investors who want to develop their business in Russia are stuck with the attitude of local officials, which is characterized by suspicion, passive support, reluctance to let in competitors.

The Asian dimension is present in the Eurasian Economic Union (EEU), which as a potentially significant regional block has a role of building a bridge between Europe and Asian Pacific region among its main tasks. Integration practice shows that it is and remains more a political than economic project, although Russian politicians claim otherwise. Russia is the biggest player in this union, as its economy is almost seven times bigger than the other EEU countries combined. Russia's large size and desire to dominate the region allow it to play a position of power by dictating its own conditions. The closest allies in the CIS integration projects Kazakhstan and Belarus are reluctant to fully surrender their sovereignty to the Kremlin, which has led to tensions in the region since 2014. Russia's economic stagnation and maintenance costs for Crimea do not allow Moscow to generously subsidize Belarus with relatively low gas and oil prices, thus increasing pressure on Minsk to integrate more closely into the Union of States. Russia needs Belarus for military strategic purposes to maintain a buffer zone between itself and the West. However, it is costly to support Alexander Lukashenka's regime. The coming years in Russia's internal development will show which of the vectors in the relationship between the two countries – integration or disintegration – will dominate after 2024.

Russia's instruments of influence go far beyond its neighbors. Russian-origin capital in Western countries has been underestimated through recent years. The money flowing from Russia into the West is not only distinguished by its large volume, but also by its specific origin, character and behavior. This capital has been obtained by stealing from the Russian population, with authorities collaborating with organized crime. Russian capital is characterized by a strong link and dependence on the Kremlin, and hence the future uses of this money. Official Russia in the West consists of a wide and branched companies, institutions and assets network to infiltrate and build their support centers in other countries. To increase the Kremlin's influence, national political parties, think tanks, universities, football clubs, charity projects are being financed and over a longer period of time become dependent on this funding. In such a way, the Kremlin is buying supporters who become Russia's political advocates at international level. It should be noted that the transfer of funds to the West is also seriously damaging to Russia itself as the money is no longer used for internal infrastructure, economic development and the improvement of the general level of prosperity. Thus, the policy pursued by the Kremlin is very costly to the Russian people themselves – huge resources are spent virtually without any meaningful return.

Not only gray money flows from Russia to Europe, the official propaganda and misinformation are full of economic narratives. Russian trolls on social networks and media controlled by the Kremlin continue to spread the message that the Baltic states are 'failed states' whose 'industry has only been destroyed after the collapse of the USSR'. Propagandists purposefully compare the economic performance of Latvia, Lithuania and Estonia with the richest European countries, rather than other former Soviet Republics, which are far worse off than the Baltics, whose economies are growing and the grow rates for a number of years have surpassed many other European countries. Deceptors do not care about real facts, they operate with 'alternative facts', or more precisely, lies. Attempts are being made to create nostalgia for the 'good times in the USSR'. The purpose of disseminating such economic messages is to undermine the trust of the citizens of the Baltic states in their public institutions and to increase the pro-Moscow views on foreign policy.

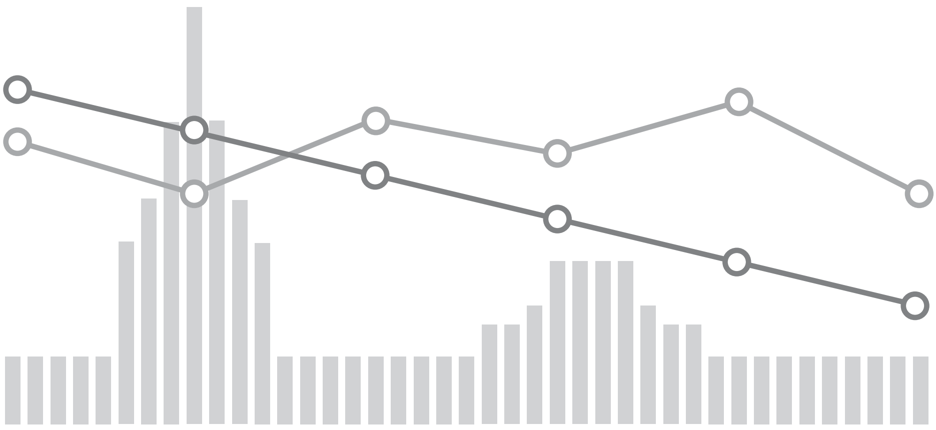
Putin's Russia has been keen to become an influential superpower, but it has failed and will not succeed in the short and medium term. High oil and other natural resource prices of the beginning of the century created comfortable conditions for Russia's political elite, but at the same time produced a stifling effect so powerful that Russia's authorities did not seize the opportunity to shift its economic model to an internationally competitive alternative. The Russian elite under Putin does not have effective public administration to work for their fellow citizens. Huge resources are wasted in an inefficient and opaque way, including outside the country, loosing an opportunity to use them locally. On the other hand, the Russian public is not stringent enough in this regard; it is easy to manipulate and its attention can be diverted to other issues such as raising Russia's international influence and fight against external enemies, large infrastructure projects (the Kerch bridge linking Russia's mainland with Crimean peninsula) and large sports events. Putin's Russia has experienced a powerful massive propaganda, which already exceeds the scale of the Soviet Union Communist efforts to dominate the minds and hearts of the people. The Kremlin is not only organizing brainwashing of its own people, it is also actively disseminating misinformation in the West. A significant part of this misinformation is related to lies about Russia's economic 'power' and failures in other countries.

The Russian elite is characterized by a symptomatic fear of losing control over the country, which takes form in both centralization of resources (depletion of regions, selective support for strategic companies and projects) and lack of support for private sector development as well as distrust of foreign investment. The state system serves to maintain the positions of the ruling elite rather than to improve the general living conditions of the society. Putin's power system has helped Putin to elevate himself and his circle of trusted individuals, whose wealth is estimated at billions of dollars. At the same time, the same system has held the general public hostage and prevented Russia from achieving the economic development and prosperity rates it would have if it had the rule of law, internal market principles and fair competition.

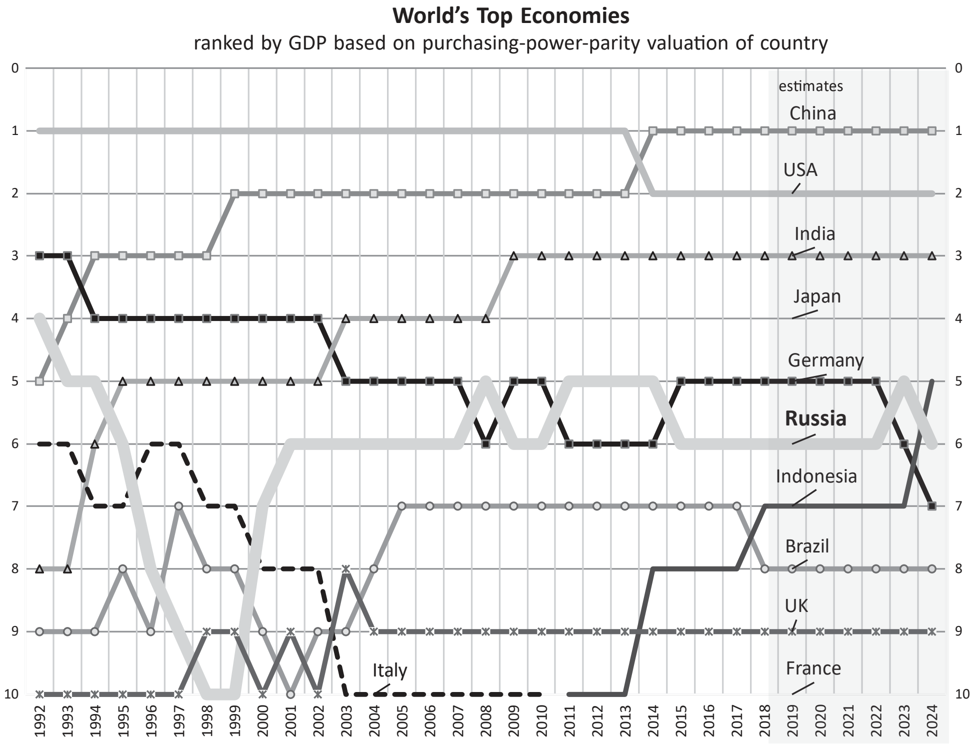
Russia is carrying out destructive actions in the countries of the European Union aimed at internal divisions and mistrust in the public administration. The Russian elite have a high level of tolerance against organized crime and corruption of officials (both internally and abroad), which serve as important tools for achieving the Kremlin's political goals. Russia's further development is marked by a number of risks that may affect its political stability. In the future, the country faces risks of a significant drop in export earnings (which it will not be able to recover in the foreseeable future), which currently accounts for a large part of budget expenditure, including social needs, infrastructure maintenance, subsidization of poor regions, etc. If in the future a default strikes Russia as in 1998–1999, it seems unlikely that Russia will borrow money from the IMF and other international creditors. Rather, it might already be China, which would certainly take advantage of such situation.

The West must take into account that Russia is an unpredictable partner, and economic cooperation with it should always be pursued having alternative cooperation partners in mind. Macroeconomic indicators and gold/currency reserves allow Russia to avoid economic cataclysms in a short term; it is impossible to be as sure for a longer period of time. Russia will be interested in continuing to buy technologies as it will only be able to produce them on a limited scale. Western governments must continue to look carefully at financial flows from Russia, given that they can be used for destructive influence.

Attachment:
State of the Russian Economy

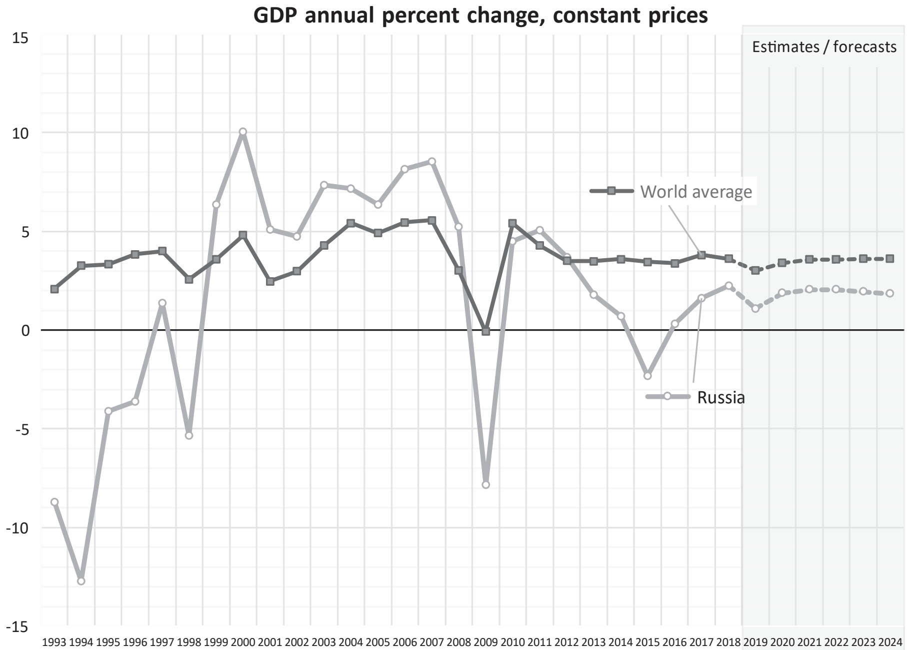


1. World's Top Economies



Source: International Monetary Fund estimates and forecasts, World Economic Outlook Database, October 2019.

2. GDP annual growth rates – Russia vs. world

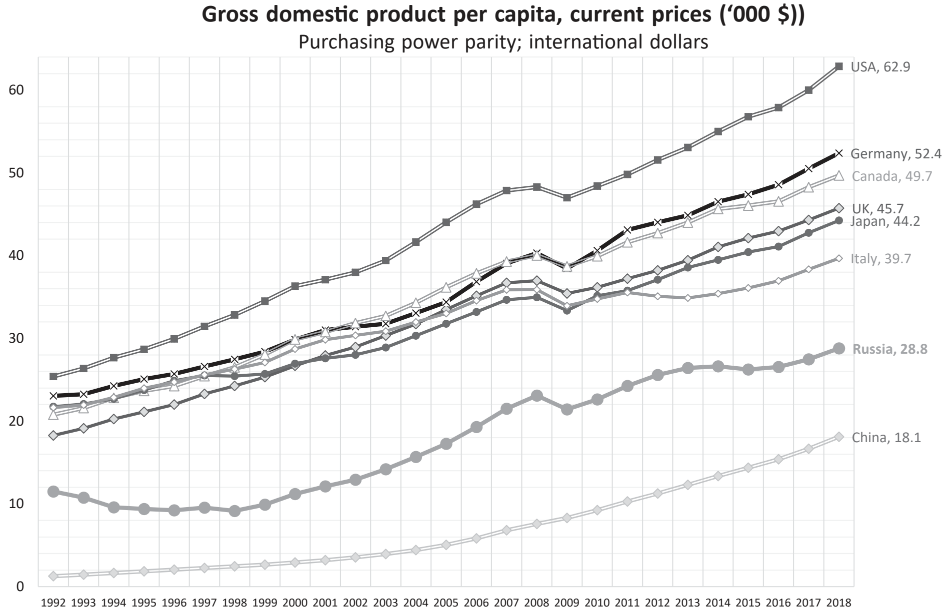


Source: International Monetary Fund estimates and forecasts, World Economic Outlook Database, October 2019.

3. Share of Russia's GDP of the world total

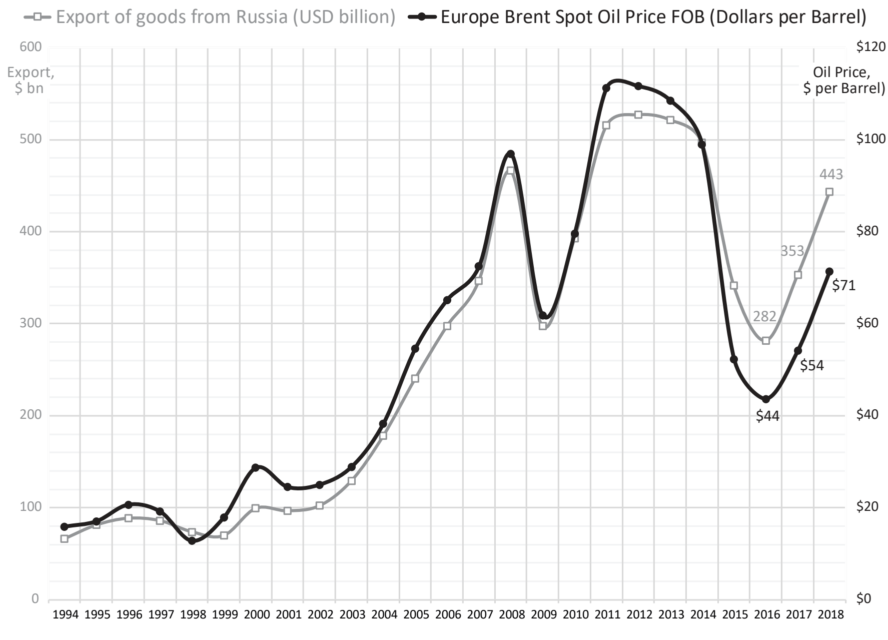
Source: International Monetary Fund estimates and forecasts, World Economic Outlook Database, October 2019.

4. GDP per capita, PPP



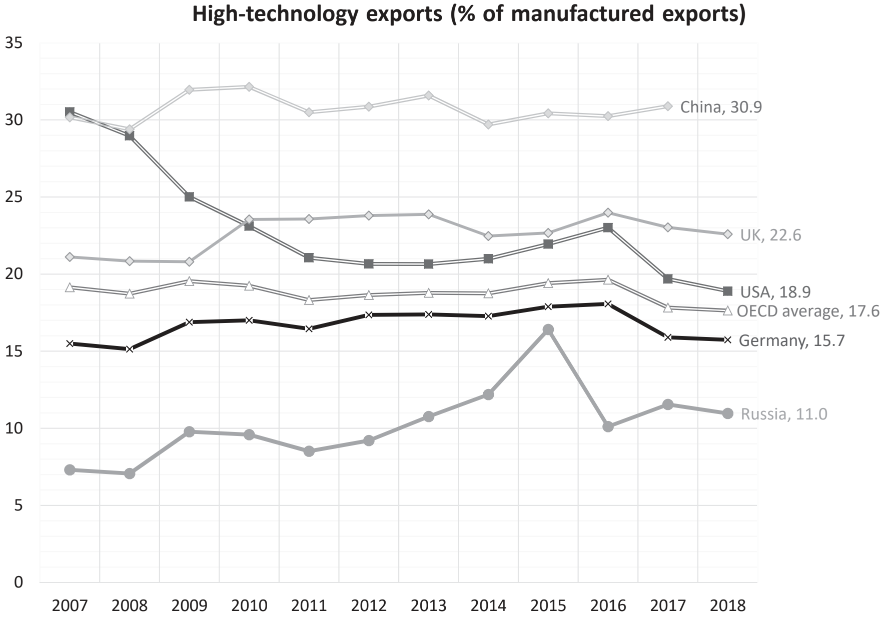
Source: International Monetary Fund estimates and forecasts, World Economic Outlook Database, October 2019.

5. Exports from Russia vs. oil prices



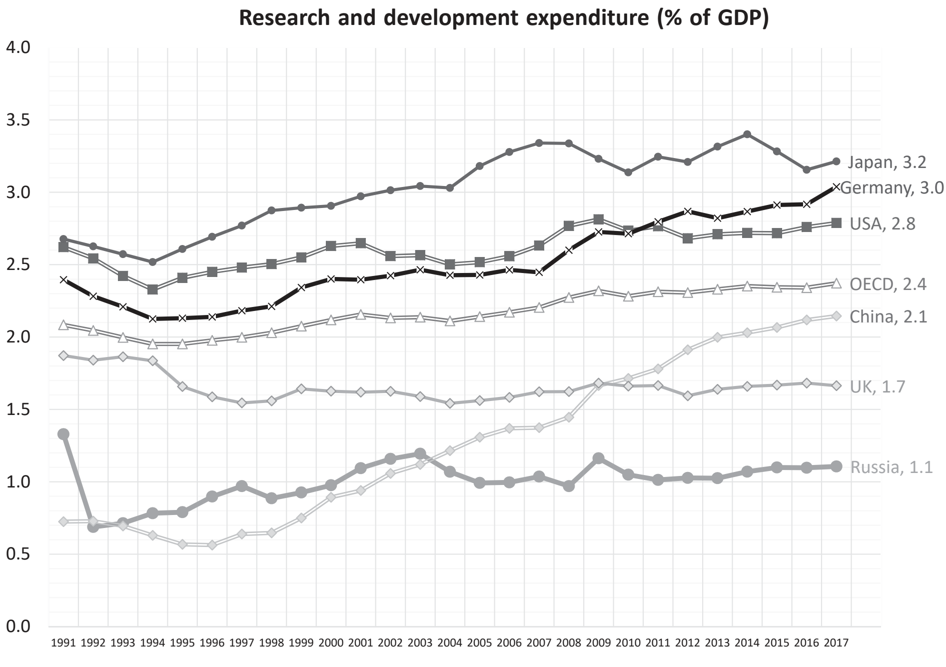
Sources: *Central Bank of Russian Federation / Thomson Reuters.*

6. High technology export share



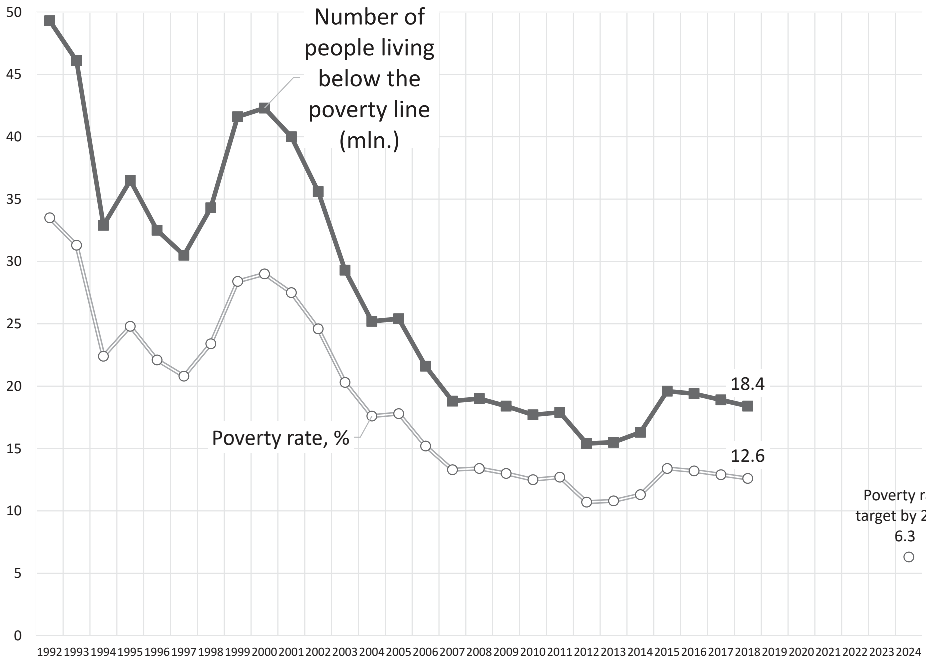
Source: World Bank.

7. Expenditure on Research & Development



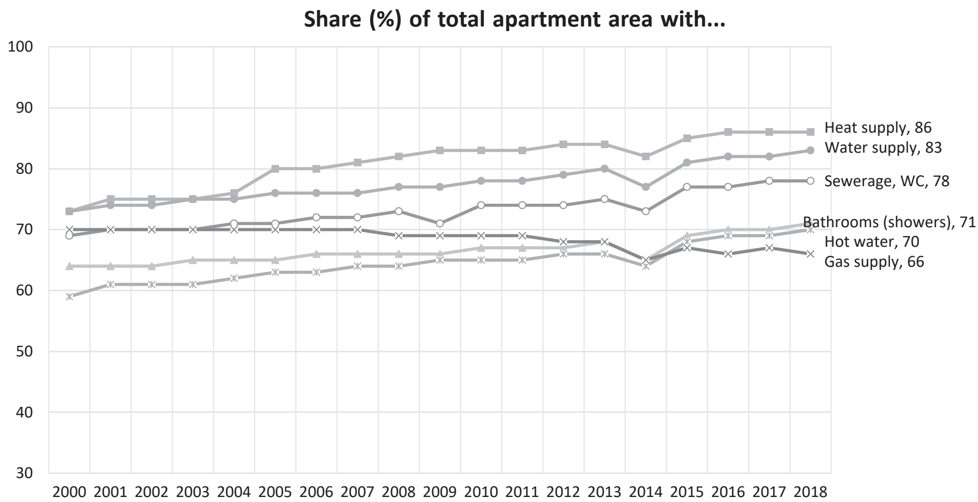
Source: Organisation for Economic Co-operation and Development.

8. Poverty



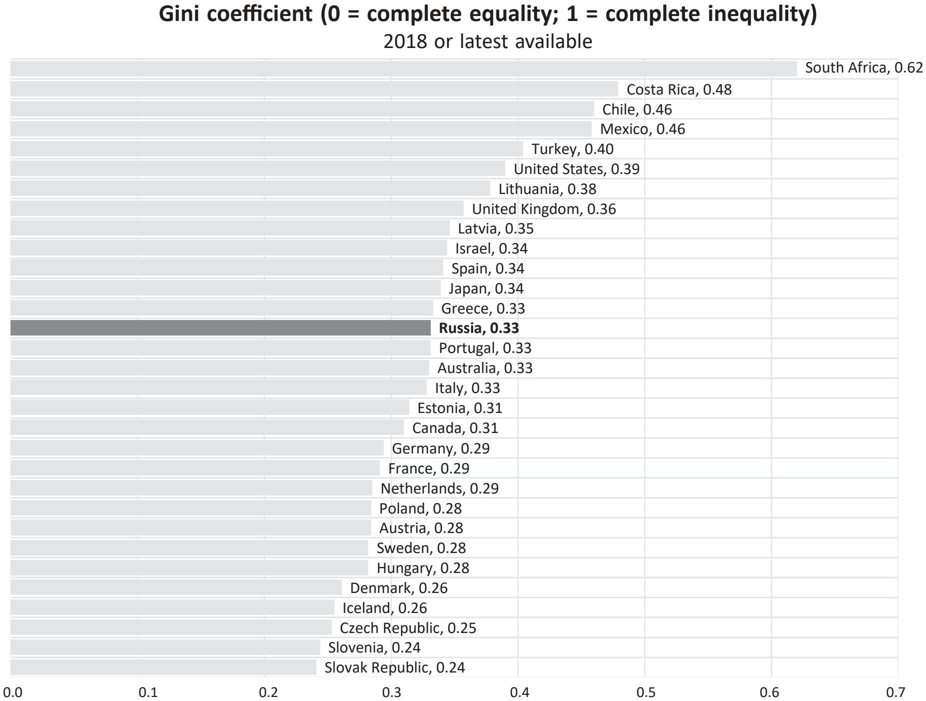
Source: Rosstat.

9. Housing conditions



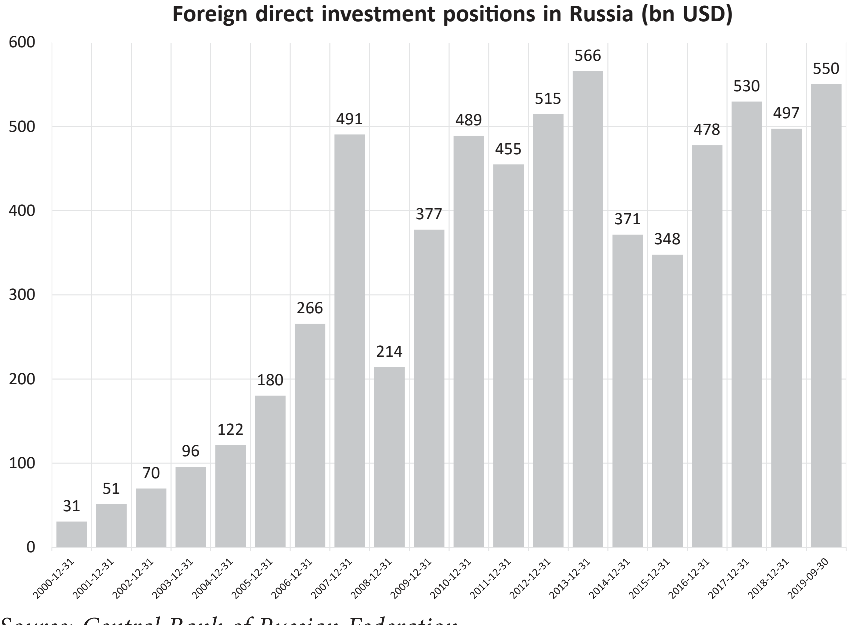
Source: Rosstat.

10. GINI index



Source: Organisation for Economic Co-operation and Development.

11. Foreign Direct Investments in Russia



Source: Central Bank of Russian Federation.

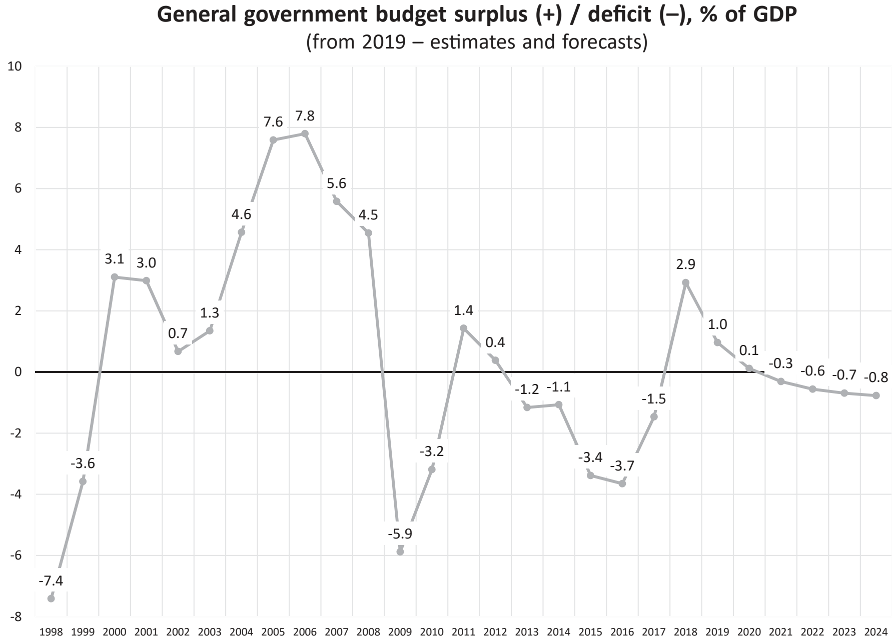
12. Foreign Direct Investments in Russia by countries

Foreig Direct Investment in the Russian Federation: positions by Partner Country

As of June 30, 2019			
Rank	**Country**	**billlions of US dollars**	**percentage of total**
-	**TOTAL**	**536.8**	**100.0%**
1	CYPRUS	159.5	29.7%
2	NETHERLANDS	55.9	10.4%
3	LUXEMBOURG	50.1	9.3%
4	BAHAMAS	28.8	5.4%
5	IRELAND	28.2	5.2%
6	BERMUDA	23.7	4.4%
7	UNITED KINGDOM	23.5	4.4%
8	FRANCE	21.0	3.9%
9	GERMANY	20.1	3.7%
10	SWITZERLAND	16.4	3.1%
11	VIRGIN ISLANDS, BRITISH	12.8	2.4%
12	JERSEY	11.3	2.1%
13	FINLAND	7.2	1.3%
14	AUSTRIA	6.8	1.3%
15	ITALY	5.3	1.0%
16	SWEDEN	5.1	0.9%
17	SINGAPORE	4.6	0.9%
18	UNITED STATES	4.6	0.8%
19	CHINA	3.5	0.7%
20	KAZAKHSTAN	3.3	0.6%
21	KOREA, REPUBLIC OF	3.3	0.6%
22	UKRAINE	3.1	0.6%
23	JAPAN	2.3	0.4%
24	BELGIUM	1.9	0.3%
25	TURKEY	1.5	0.3%
26	HONG KONG	1.3	0.2%
27	BELARUS	1.2	0.2%
28	LATVIA	1.0	0.2%
29	UZBEKISTAN	0.9	0.2%
30	DENMARK	0.9	0.2%

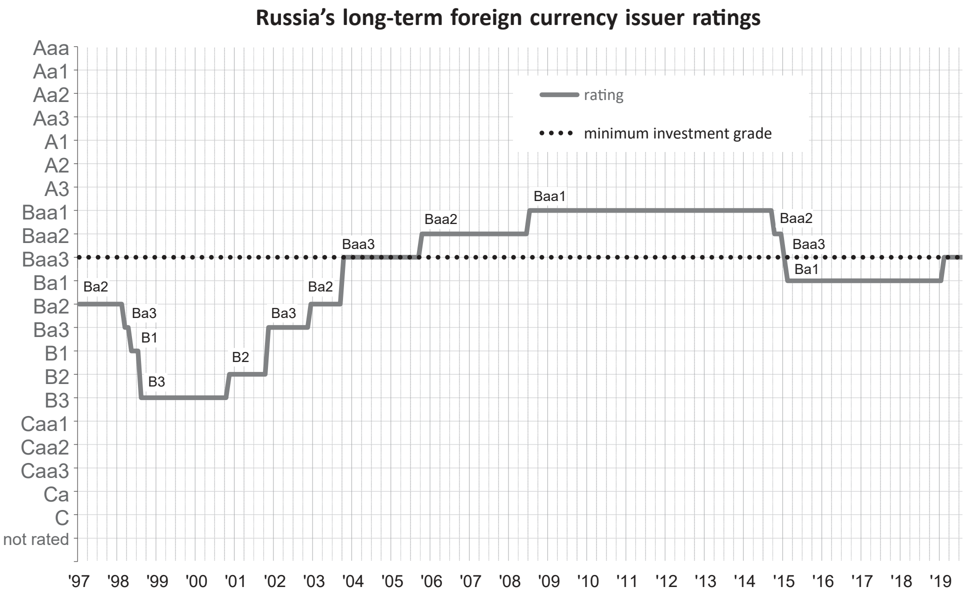
Source: Central Bank of Russian Federation.

13. Government surplus / deficit



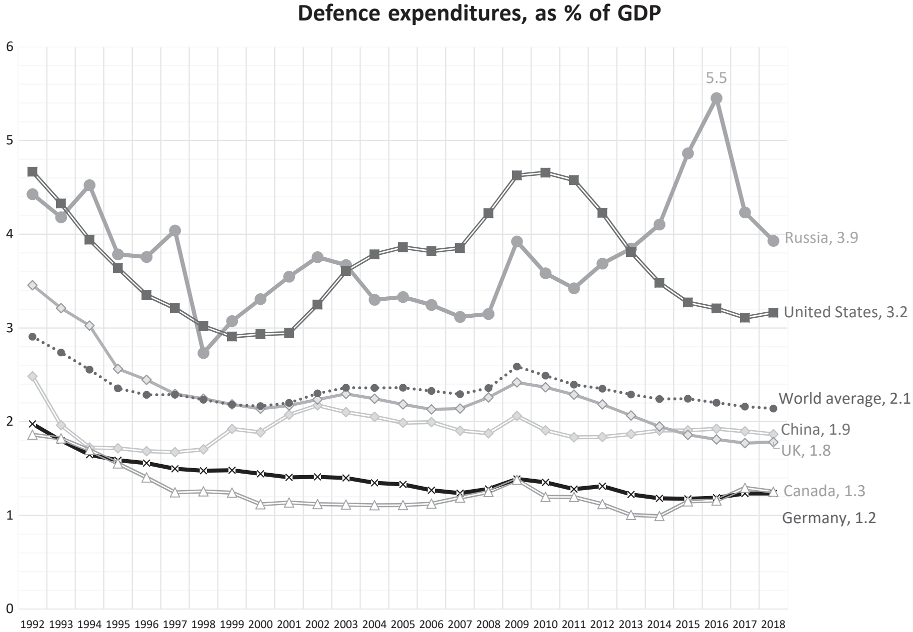
Source: International Monetary Fund, World Economic Outlook Database, October 2019.

14. Credit rating



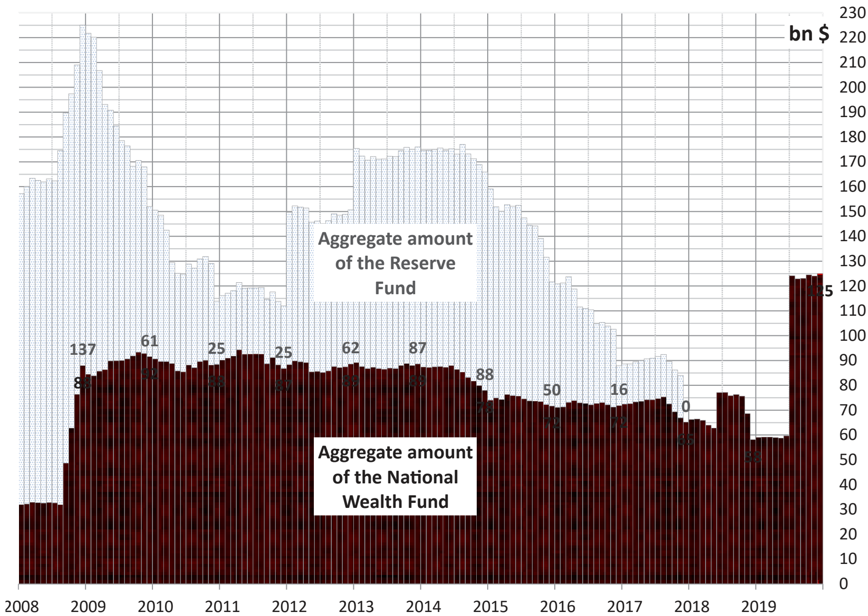
Source: Moody's.

15. Government expenditure on defence



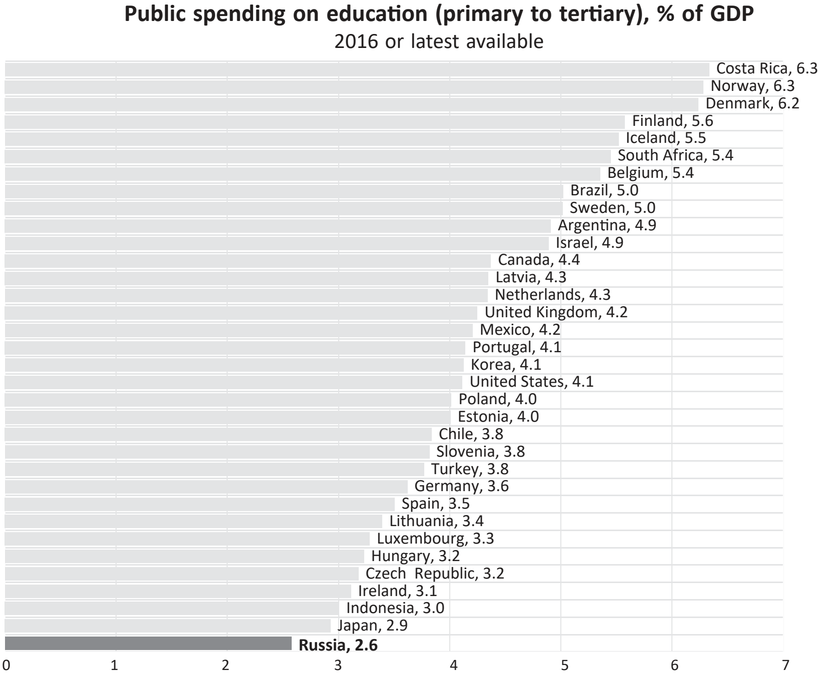
Source: World Bank.

16. Reserve funds of Russia



Source: Ministry of Finance of Russian Federation.

17. Government expenditure on education



Source: Organisation for Economic Co-operation and Development, Education at a glance 2019.

18. Corruption Perception

Source: Transparency international.

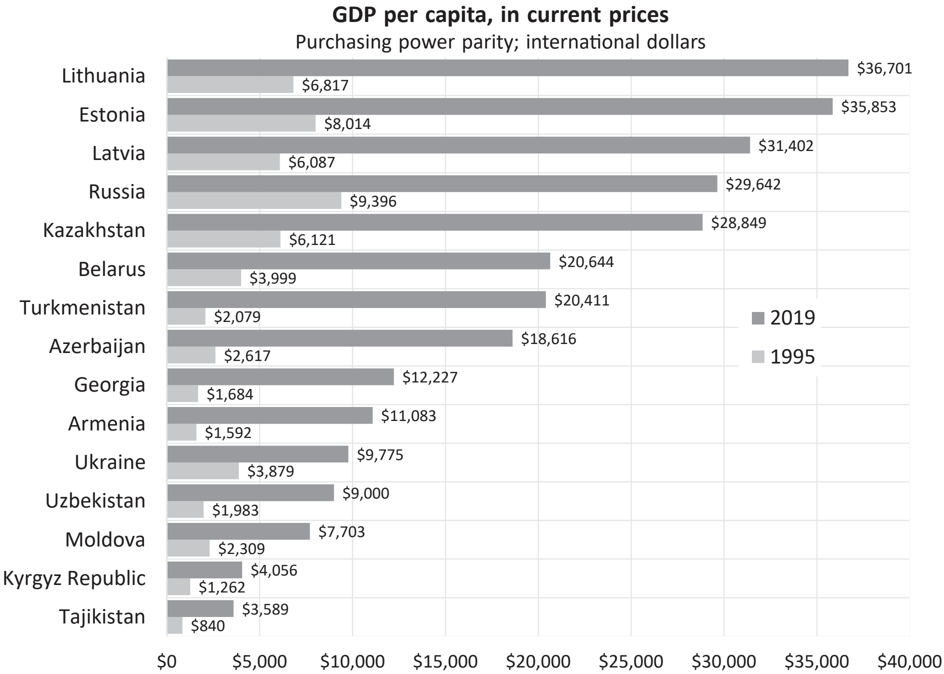
19. Ease of Doing Business

Source: World Bank.

Notes: Current calculation of Russia's "Doing Business" index is based on valuation of 2 cities – Moscow (70% weight) and St. Petersburg (30% weight) – it does not reflect overall business environment in Russia.

In the past years, several revisions of "Doing Business" methodology have been made – rankings calculated according different methodologies are not comparable over time.

20. GDP per capita in countries – former part of USSR



Source: International Monetary Fund estimates and forecasts, World Economic Outlook Database, October 2019.

Author credentials

Mārcis Balodis is a researcher at the Centre for East European Policy Studies. He obtained BA and MA degrees in International Relations at Riga Stradins University, had previously worked in Ministry of Defense of the Republic of Latvia as a coordinator of applied research activities on domestic and international level. Main research focus includes analysis of Latvia-Russia relations, as well as the impact of hybrid warfare activities on political processes. Previous work includes being a co-author of a study "Latvian Regions and Foreign Policy: The Case of the Russian Factor" at the Centre for East European Policy Studies.

Maria Domańska, PhD is a Senior Fellow at the Warsaw-based Centre for Eastern Studies (OSW) where she has been working since 2015. She specializes in Russian domestic policy, with a special focus on Russian federal and regional elites, formal and informal aspects of Russian political system, state propaganda, politics of memory, and domestic determinants of the Kremlin's foreign policy. In 2006–2015, she worked for the Polish Ministry of Foreign Affairs, including as the Head of Political Section in the Embassy of Poland in Moscow (2012–2015). She is the author of the book *Determinants of integration and disintegration processes in the post-Soviet area*, published in Warsaw in 2013 (in Polish). She is also an author and co-author of numerous papers on Russian domestic politics, including Kremlin's regional policies, government–society relations, and the logic of development of Russian authoritarian regime. Her most recent publication is *Putinism after Putin. 'Deep structures' of Russian authoritarianism*, OSW Studies 78, October 2019. Selected publications in English are available at https://www.osw.waw.pl/en/search?text=domanska&sort_order=DESC

Janis Hermanis is a finance and macroeconomics expert in Latvian Employers Confederation. He is a member of the Statistical Council of Latvia. He graduated from University of Latvia with a Master degree in Business Economy. He has worked as a senior analyst in "Mortgage and Land Bank of Latvia" (later – Development Financial institution "Altum") where he did analysis of different industries and markets. His has also working experience as a public sector efficiency advisor in The State Chancellery of Latvia. J. Hermanis regularly publishes his opinion with statistical data and comments in mass media about economic, social and international topics.

Alexander Golts has received an MA in journalism at the Department of Journalism of the Moscow State Lomonosov University in 1978. From 1980 till 1996 he worked with the *Krasnaya Zvezda* (Red Star) editorial board, Soviet then Russian military daily (Moscow). In 1996–2001, he served as a military editor of *Itogi*, a premier Russian news magazine (Moscow). He had worked for the magazine *Yezhenedelnyi journal* (Weekly) as a deputy editor-in-chief (Moscow) in 2001–2004. Currently, he works as a deputy editor for the website *EJ.RU*. He runs a column for the *Moscow Times*. A. Golts spent a year-long term at the Center for International Security and Cooperation (CISAC) of Stanford University as visiting fellow in 2002–2003. He is an author of many publications with military themes.

Dr. Mārtiņš Kaprāns is a researcher at the Institute of Philosophy and Sociology, University of Latvia, and an associated expert at the Washington-based Centre for European Policy Analysis. He received PhD in Communication Science at University of Latvia in 2012. His current research interests entail Baltic labor migrants in the UK, the ideological polarization of Baltic societies, and Russian-speakers in post-Soviet area. His most recent articles are published by *Journal of Baltic Studies*, *Memory Studies*, and *Euro-Asia Studies*.

Andis Kudors was an Executive Director of the Centre for East European Policy Studies (2006–2019). A. Kudors is a 1996 graduate of the International Law and Economics Program at University of Latvia's Institute of International Affairs. From 2005 until 2011, he studied Political Science at the University of Latvia, specializing in Latvian-Russian relations and obtained a BA and then an MA in Political Science. His research interests include current foreign policy trends in Eastern Europe, Russian foreign policy, Russian compatriot policy, public diplomacy, propaganda, and disinformation. He is a member of the Foreign Policy Council at the Latvian Ministry of Foreign Affairs since 2011. Kudors is an author of many analytical articles about Russian foreign policy and Latvian security. He is the editor of several books, such as "Fortress Russia: Political, Economic, and Security Development in Russia Following the Annexation of Crimea and its Consequences for the Baltic States" (2016), "The War in Syria: Lessons for the West" (2016), "Belarusian Foreign Policy: 360°" (2017). Andis Kudors had been Fulbright scholar at the Kennan Institute, Woodrow Wilson International Center for Scholars in Washington DC, USA (2014–2015).

Dr. Kai-Olaf Lang is a Senior Fellow at the German Institute for International and Security Affairs of the Stiftung Wissenschaft und Politik, a foreign-policy think tank based in Berlin. He holds a diploma in public administration and a PhD in Political Sciences. Previously, he worked as a research fellow at the Federal Institute for Eastern and International Studies (Bundesinstitut für internationale und ostwissenschaftliche Studien, BIOst) in Cologne. His fields of specialization include: countries of Central and Eastern Europe (CEE), including their transformation, domestic political developments, foreign and security policy, bilateral relations with Germany; EU enlargement and implications; security issues in CEE and European Neighborhood Policy. He is a member of the Deutsche Gesellschaft für Osteuropakunde, of the German-Polish Kopernikus-Group, of the Council of the German-Czech Discussion Forum, of the Editorial Board of Przegląd Zachodni (Poznań), of the Advisory Board of Aspen Review Central Europe (Prague) and of the Scientific Council of Nowa Res Publica (Warsaw).

Marius Laurinavičius is as Senior Expert at the Vilnius Institute for Policy Analysis. Previously he lived in Washington DC where he worked at the Center for European Policy Analysis and served as a fellow at the Hudson Institute. He's the author of "Weaponizing Kleptocracy: Putin's Hybrid Warfare" and "A Guide to the Russian Tool Box of Election Meddling: a Platform to Analyse the Long Term Comprehensive Kremlin Strategy of Malign Influence". Before moving to think tank business M. Laurinavičius had worked for the largest Lithuanian media group 'Lietuvos Rytas' for almost 22 years. Back over the years working as journalist Marius Laurinavičius has become Lithuania's leading foreign and security expert. His many contributions have been recognized by Lithuanian political leadership as well, as he received several official awards for his contribution for Lithuanian foreign policy. He has a Master degree from the Institute of International Relations and Political Science of Vilnius University

Vladimir Milov is a Russian opposition politician, publicist, economist, and energy expert, and an economic adviser to the Russian opposition leader Alexey Navalny. Mr. Milov has used to work with the Russian Government in late 1990s and early 2000s, serving as the Deputy Minister of Energy of Russia (2002), adviser to the Minister of Energy (2001–2002), and Head of Strategy Department at the Federal Energy Commission, the natural monopoly regulator (1999–2001). Mr. Milov was the author of major energy reform concepts, including the concept of market restructuring and unbundling of Gazprom, which was banned from implementation by President Putin. Since leaving the Government, he became a founder and the President of the Institute of Energy Policy, a leading independent Russian energy policy think tank. Mr. Milov is one of the major public critics of Vladimir Putin in modern day Russia. He is the co-author of the critical public report "Putin. The Results", sharply criticizing the flaws of Vladimir Putin's policy, written together with Boris Nemtsov and first published in 2008 (with updated versions being reissued from time to time ever since). Currently, Mr. Milov works as an economic adviser to Russian opposition leader Alexey Navalny and hosts the weekly economic talk show at the Navalny Live Youtube channel.

Vita Spivak is an expert on China. She used to be an analytical projects head at "Expert RA" credit rating agency. Prior to that, she worked as the Russia in the Asia Pacific Program Coordinator at the Carnegie Moscow Center. Her research interests focus on the Sino-Russian relationship, the contemporary Chinese economy and foreign investment in the energy sector, the anti-corruption campaign in the PRC, and the development of the One Belt, One Road Initiative (OBOR). She holds a BA in Chinese History from Moscow State University and an MA in Economics from Gubkin Russian State University of Oil and Gas. She also holds an MSc in Contemporary Chinese Studies from the University of Oxford.

Dr. Dmitry Oreshkin graduated from Moscow State University, Faculty of Geography (1975). He is a Leading Research Associate at the Institute of Geography, Russian Academy of Sciences. Oreshkin holds a PhD in Geography (1979), specializing in Electoral Geography and Regional Politics. In 1995–2007, he acted as the Chief Analyst and speaker of the RF Central Election Commission, responsible for visualization, presentation and analysis of electoral data. He was a former member of the Committee for Human Rights under the Russian Federation President (2009–2012), and leader of the Committee group for electoral rights. D. Oreshkin was also one of the initiators of public movements for electoral observation and independent vote counting *Grazhdanin Nabludatel* (Mr.Observer) and *Narodny Izbirkom* (Alternative Public Election Committee). Nowadays he writes for *Novaya Gazeta*, *Ogoniok*, *Sobesednik*, *The New Times*, *Echo Moskvy* radio and website, and many more. He is a full member of the Citizen Initiative Committee started by former Russian Federation Finance Minister Alexey Kudrin. D. Oreshkin is a Council Board member of the Liberal Mission foundation of Evgeny Yasin and was a Laureate of the PolitProsvet award in 2013.

Dr. Kirsten Westphal is based at the Stiftung Wissenschaft und Politik (SWP), the German Institute for International and Security Affairs in Berlin. Dr. Westphal is assigned for International Energy Relations and Global Energy Security at the Institute. She was a Member of the Expert Panel to the Global Commission on the Geopolitics of Energy Transformation in 2018–2019 and contributed to the Commission's Report "A New World", published in 2019. In parallel, she has been leading the Project "Geopolitics of Energy Transformation 2030 (GET 2030)" supported by the German Federal Foreign Office. Over the course of 2019/2020, the follow-up project (EU GET 2030) has been examining the geopolitics of the energy transformation from the EU's perspective. This project involves IFRI in Paris, PISM in Warsaw; and Real Instituto Elcano in Madrid. Since 2015, Westphal has been conducting a series of Track 2 dialogues with Russia and Poland, with the kind support of the German Federal Foreign Office. Previously, she has worked as a consultant in the energy industry. Dr. Westphal has published widely on international energy relations and EU external energy relations. Her books include Global Energy Governance in a Multipolar World (Aldershot/ Burlington Ashgate 2010); and The Political and Economic Challenges of Energy in the Middle East and North Africa (Routledge, 2018). Her recent publications on the geopolitics of energy transformation, on energy security reimagined in times of decarbonization and on the operationalization of SDG 7 have appeared in Nature, Global Policy, Energy Strategy Review, European Energy Journal and at SWP.

The Centre for East European Policy Studies (CEEPS) is a non-governmental, non-profit organization founded in Riga in 2006. The main objectives of CEEPS are: to make its contribution to the development of Latvian foreign policy by doing research work in the scientific fields of politics, history, and the economy of Eastern European countries; to develop cooperation with scientific institutions and other organizations of Latvia and foreign countries; to be aware of, and explain, Latvia's state interests abroad. The most recent CEEPS studies have focused on the influence of Russian public diplomacy and propaganda on the social and political processes in Russia's neighboring countries. CEEPS activities up until now have been financially supported by the following institutions: the Ministry of Foreign Affairs of the Republic of Latvia, the Ministry of Justice of the Republic of Latvia, the Ministry of Culture of the Republic of Latvia, the Social Integration Foundation (Latvia), the Konrad Adenauer Foundation and Friedrich Ebert Foundation (Germany), the National Endowment for Democracy (US), the American Latvian Association (ALA), the NATO Strategic Communications Centre of Excellence, the European People's Party (EPP) Group at the European Parliament, and private donors.

Friedrich-Ebert-Stiftung (FES) was founded in 1925 as a political legacy of Germany's first democratically elected president, Friedrich Ebert. Ebert, a Social Democrat from a humble crafts background who had risen to hold the highest political office in his country, in response to his own painful experience in political confrontation proposed the establishment of a foundation to serve the following aims: furthering political and social education of individuals from all walks of life in the spirit of democracy and pluralism, facilitating access to university education and research for gifted young people by providing scholarships, contributing to international understanding and cooperation. Friedrich-Ebert-Stiftung, banned by the Nazis in 1933 and re-established in 1947, continues today to pursue these aims in all its extensive activities. As a private, cultural non-profit institution, it is committed to the ideas and basic values of social democracy. Current, particular important topics of our work are: fair society, innovation and progress, active democracy.

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Centre for East European Policy Studies
Ausekļa street 11–411, Riga, LV-1010
www.appc.lv
info@appc.lv

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Aspazijas street 5, Riga, LV-1010
www.apgads.lu.lv
apgads@lu.lv