Chapter 6

The Worst Friends: EU-Russian Economic Relations at a Time of Hostility

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When we mention Russian–Western economic relations, we implicitly mean Russian—EU cooperation: of overall Russian exports of $333.5 billion in 2015, 57% went to the EU and only 3.2% to North America. The difference is easily explained without relying on traditional rhetoric about historical hostility between Russia and the United States: the two countries are located quite far from each other, making shipments more expensive, and in addition Russia's major way of exporting—through pipes—is impossible as far as the United States or Canada are concerned. The United States and Canada also have much closer and more flexible sources of hydrocarbons, which is Russia's major export item. Russia's trade balance with the United States (about $6 billion in 2015, with imports of about $10 billion and exports of about $4 billion) is less than the difference in calculation of the amount of imports from China to Russia made by Russian and Chinese statistical agencies. Such trade isolation affects financial relations: 75% of loans to Russian banks are extended by European financial institutions; only 15% came from the American banks. Moreover, the United States accounts for only 0.7% of foreign direct investment in Russia.

It would be rather natural to conclude that such mutual economic indifference makes political confrontation easy and harmless. Knowing there is little to lose, politicians from each side of the Pacific use downright political hostility between the United States and Russia as a means for achieving domestic political goals. It is quite hard to expect elites in either country to forgo the clear advantages such confrontation may offer them in favor of pursuing unclear and rather limited opportunities that may arise from potential economic cooperation. Hence, while discussing the potential developments of Russia–West economic relations, it is more logical and meaningful to focus on EU–Russia cooperation.

In this chapter I review the recent history of economic relations between Russia and European Union member states in an attempt to understand the habits and rationale behind the actions and inactions of the parties, and offer a rough forecast of the future of such relations.

EU-Russia Economic Relations: Worst Friends

EU–Russia political relations have had their ups and downs, ranging from hostility to dormancy to renaissance and even active discussion of potential Russian membership in the EU. Behind the curtain of politics, however, economic and in particular trade and financial relations between Europe's two major players have been driven by mutual pragmatism and remained quite stable for decades. Geography as well as complementarity in resources and technologies have over time made the EU and Russia essential trade partners, with the opportunity cost of potential substitution being unaffordable at least in the short run.

Although relations are critical to both parties, Russian international trade is much less diversified and more EU dependent. Russian merchandise trade with the EU has historically constituted over 50% of Russian trade with the entire world, while EU trade with Russia does not exceed 10-12% of its worldwide trade. Russian trade turnover with the other Great Neighbor—China—rarely exceeds 20% of that with the EU, despite China's GDP constituting 60% of that of the EU, China's population exceeding the population of the EU by a factor of 2.5, and Chinese production costs being China is remarkably lower. The strength of Russian-EU economic ties over Russian-Chinese economic relations cannot be explained simply by marginally lower transportation costs and/or better quality of European goods. Other factors are at play.

At First Glance: Hydrocarbons for Machines

At first glance, EU-Russian economic relations are in large part limited to the Russian supply of hydrocarbons (85–90% of EU imports from Russia, 30–35% of total EU imports of fuels and chemicals) and EU supply of machinery and equipment (over 65% of Russian imports from the EU, however only 6-7% of overall EU machinery exports). The figures can lead to the conclusion that while the EU is definitely dependent on Russia in such a sensitive area as energy security, Russia is highly dependent on the EU in a wide range of supplies, and, beyond that, Russia is dependent on its appetite for hydrocarbons, which still account for almost 50% of Russia's total exports. Sales of hydrocarbons still bring Russia over $160 billion a year, accounting for 13% of Russia's GDP, almost 90% of its imports and 10 times its current account balance.

Beyond the obvious monoproduct nature of Russian exports, trade relations between Russia and the EU from the quantitative side look well balanced: Russia's trade-to-GDP ratio with EU members is similar to that of an average EU member state. Russia's GDP in 2014 was roughly 9% of that of the EU28 on the whole, and its trade turnover with the EU was roughly 10% of intra-EU trade turnover. Even Russian neighbors such as Poland, which could have been more active in relations with their eastern partner, show the same proportion: Polish trade with Russia is limited to 9.5–10% of Polish trade with the rest of the EU.

Gas Exports: Stable Volumes, Lower Prices

Oil and gas are the main components of Russian exports to the EU. The demand for natural gas in Europe was rising until 2010, and along with rising demand figures most forecasts were predicting even greater future need for fossil fuels. That was a time of huge infrastructural projects, ranging from new pipelines from Russia to new LNG ports. However, the pressure of high oil prices on economies resulted in the rapid growth of emerging energy-saving technologies and employment of renewable energy sources. As a result, since 2010 gas consumption has declined. In 2014 it fell to 1995 levels, and even marginal growth of about 7% in 2015 due to colder weather did not alter the trend. On the other hand, the decrease in EU gas consumption has been less than the decrease in EU domestic gas production, hence EU28 gas imports of gas are steady if not growing.

Russia supplies 30-40% of EU gas imports. The amount supplied has grown 17% since 2005, despite the decline in EU gas consumption. In fact, Russia is the only importer of gas to the EU with extra capacity: its pipelines to Europe have a total capacity of 309 bcm; total Russian gas exports to the EU do not exceed 160 bcm. Even with the dramatic changes in the political landscape in 2014 and 2015, which resulted in the consecutive alienation of Ukraine and (temporarily) Turkey, the collapse and sudden rebirth of the South Stream project, and the seemingly final decision to eliminate the transit of gas through Ukraine, the capacity of the remaining pipelines (still putting South Stream aside as not reliable) is around 120 bcm. In addition, the famous Nord Stream project (where Russia deliberately pays a high fixed price for gas transportation regardless of physically transported volumes to the consortium where Gazprom Switzerland has a significant share, thus legally transferring much money to Switzerland) offers an additional possible increase in capacity that is both rather easy and obviously beneficial for the Russian side, especially if we consider the large amounts of money cronies of the Russian leadership earn from such construction projects.

Indeed, Europe can physically substitute Russian gas supply with a combination of Algerian and other North African gas (unused capacity 40-45 bcm), an increase in consumption of Norwegian gas (20 bcm more) and by taking a larger share of the LNG received through Regas terminals (a potential increase of up to 128 bcm based on current and soon-to-be-built capacity)—not to mention future potential pipelines from Iran/Turkmenistan and/or the Persian Gulf. However, the prices of liquefied gas are still substantially higher than that of pipeline-transported gas, and Russia with its spare capacity and enormous sunk costs has shown itself to be very flexible in pricing when it comes down to tough negotiations.

It is therefore reasonable to believe that the supply of Russian gas to the EU will be sustained over the long run. The only change we could expect concerns the role of Germany in EU–Russian gas relations. With the rise of the role of Nord Stream, Germany will gradually become not only the largest importer of Russian gas, but also the largest distributor and the key hub for Russian gas to other European countries. It is still unclear how the distribution will be organized, and it definitely will need more investments. Not everyone in Europe is in favor of this, given the persistent idea that the EU should reduce its gas dependency on Russia through greater diversification of suppliers. But because German companies and budgets will benefit from this new situation we can expect that the project will obtain enough support.

Oil Exports: Preparing for Decline

The EU is still the world largest oil consuming region, although demand has dropped 17% since 2005 to below 12.5 mbd (being flat in 2015 for the first time in 10 years). A number of analysts expect demand to continue to slide 0.5% per year over the next five years. However, the EU is still heavily dependent on oil imports—in 2013, 83% of EU consumption was imported.

Russia is the single largest supplier of oil to the EU, with about a 29% share of total EU imports (for comparison, Norway supplies 12.6%, Nigeria 9%, Saudi Arabia 8.9%). Russian dependence on European oil consumption is even higher: the EU share of Russian oil exports is about 75%, with over 70% of it being transported by pipelines (and hence hard to divert to another destination).

Russian oil exporters to the EU are facing a range of challenges, including declining EU demand for imported oil, European programs seeking to boost energy efficiency (including those targeting the shift to hybrid engines from currently mostly diesel ones—75% of oil consumed in Europe is used as a fuel for ground transportation vehicles), active competition from the United States and Middle East countries, the current increase in transportation capacity from the Middle East to Europe through the Suez Canal, and the future potential increase of such capacity due to the construction of trans-Turkey and trans-Syria pipelines. However, the situation is even more complicated: starting in 2018 Russian upstream capacity is about to decrease, and by 2025 could fall as low as 50% of current capacity. In this regard, decreasing sales to Europe could result more from failing supply than shrinking demand.

The EU and Russia should prepare themselves to a gradual loss in turnover. Russians must look for other products they may be able to offer to the EU to substitute for the decreasing amounts of oil in the trade balance. European refineries, in turn, should prepare themselves for a switch to other sorts of oil from the Urals. Unfortunately, since none of these changes will occur in the short run, no one in Russia is dealing with these issues. It is as if the threat of the declining Russian oil production never existed. Although the best probable response would be to try to utilize the Mexican scenario and try to diversify imports from the EU by winning the outsourcing production market for EU companies, Russia's traditional policy of industrial isolation does not suggest that such a way out will be considered any time soon.

Machinery Imports: Vital for Infrastructure

Russian equipment purchases from the EU have long exceeded €50 billion per year, with transport equipment accounting for at least €14–15 billion per year, and two-thirds of that represented by passenger cars and trucks. Imports of elecommunications and data processing equipment from the EU constitute at least €10 billion per year. While a larger share of consumer electronics imports comes from China, Korea and other countries, the EU still supplies most of the industrial telecom and data equipment, and uninterrupted provision of such equipment, as well as spare parts and services, is critical to Russia's infrastructure.

Two other critical areas of import are speed trains and railroads operation equipment and civil aircraft: the EU sells over €4 billion in non-automotive transportation vehicles to Russia each year officially, and this does not include lease arrangements with aircraft and spare parts used for offshore servicing: 93% of passenger turnover in Russia is served by imported aircraft, mainly from Airbus and Boeing.

In addition, the EU supplies over €25 billion worth per year of other machinery (most of which is non-electrical). Although theoretically other types of machinery currently imported from the EU could be more easily substituted by non-EU suppliers, in practice the vast majority of the industrial equipment is being bought for the replacement of particular elements in complex technological chains and requires specific models; spare parts and consumables are also a large part of such supplies.

Investment Balance: Limited but Important

Net investment into Russia from EU countries (due in large part to the use of Dutch, Cypriot and other holding structures by Russian investors) has averaged over 80% of total foreign investment in Russia over the long term. Although this fact does not prove that European investors have a special attitude towards Russian markets, it is a clear sign of the deep structural dependency of Russian financial and investment markets on European infrastructure and legislative systems. Major Russian tycoons keep their assets in European and quasi-European structures—OAO Novolipetsk Steel through Cyprus, Alfa Group through Gybraltar, etc. Beyond that, true European investors have also heavily invested in Russia. German investors only hold stocks for over €25 billion. 611,500 employees (about 1% of the workforce) are employed by EU28-affiliated companies in Russia. European infrastructure has also helped to attract capital to Russia. The amount of external debt outstanding raised by Russian companies through issuance of Eurobonds on the European stock exchanges exceeds $180 billion—over 35% of Russia's total external debt.

The reverse process has also been in place at least since the collapse of the Soviet Union: Russian entrepreneurs (mostly legally) and officials (mostly illegally) have exported at least $1 trillion dollars from the country, and while the major part of the funds are nested in Swiss banks, according to different unofficial sources over $100 billion have been put in German and Austrian banks. Even Cyprus had up to €35 billion from Russian sources at its peak. The number of houses and apartments bought by Russians in Europe is estimated by the Russian press as exceeding 500,000 (most of them in eastern Europe). Although this may be an overestimation, the degree is correct: Russians are important buyers of real estate not only in Bulgaria, but also in London, Berlin and Frankfurt. Russian beneficiary owners own 3% of companies registered in the EU.

The freeze in incoming foreign direct investment hit Russia in 2014; since then the flows have been negligeable. In 2016 and 2017, however, German and Finnish companies started to return to the market, along with other European enterprises, ahead of their peers from other parts of the world (except for a vague transaction with Rosneft shares allegedly made by Glencore and Qatar Fund, which had all the features of a disguise for the theft of the shares by current stakeholders). In private conversations many European companies express their willingness to increase their exposure. On the other hand, the capital flight to Europe from Russia has never stopped.

New Bureaucratic Reality: Tender Pressure

The EU and Russia have long been cooperating along the terms of their 1994 Partnership and Cooperation Agreement. Many discussions have been held about the need to provide a more comprehensive framework, to shift to more substantive and legally binding commitments not only in civil areas such as security, justice or education, but also in economic cooperation, trade and investment. At the 2008 Khanty-Mansiysk summit an attempt was made to move to a new version of the agreement, but the negotiations were never completed. Since 2003 the EU and Russia sought to advance their cooperation within the framework of the so-called "common spaces program." This resulted in many different initiatives, ranging from an unsuccessful attempt to allow visa-free travel to much more successful cooperation in a space work program. In 2010, following the Rostov summit, the Partnership for Modernization program was launched. The program included substantial economic elements as well as joint technical modernization aspects.

In 2014, however, following the annexation of Crimea and destabilization in eastern Ukraine, all programs were suspended and a number of sanctions were imposed: European development banks put all financing projects on hold; several companies and individuals from Russia were banned access to financial markets and financing (a number of European bankers told the author that recently the banks in the EU were unofficially recommended not to place any Russian financial instruments on new issue). Export to Russia of dual-purpose technologies, complex oil extraction technologies and equipment and few other advanced technologies and goods was also prohibited.

Although the contemporary rhetoric is rather hostile, and the sanctions are actively used by the Russian government as an excuse for the current economic downturn, the real effect from sanctions is minimal: the ban on financing coincides with the period when the Russia's balance shrank due to recession and its overall external debt decreased almost 30% even without sanctions. The oil price drop led to a suspension of any development of high-cost oil wells, thus the respective technologies are neither in use or in need. The export of dual-purpose goods has been minimal, and the ban does not have any significant effect on Russia's economic situation.

Russia symmetrically responded to the sanctions by banning imports of a number of agricultural products. The measure, which was officially targeting import substitution, in reality caused temporary deficits, substantial loss of quality of several food products on the Russian market, and significant inflation of prices of core food—with little negative impact on European suppliers.

Food Imports: Much Ado about Nothing

The export of food and agricultural products to Russia (so much in discussion now with regards to sanctions) has never exceeded €10-11 billion per year—a pathetic 3.5% of the turnover between the countries on average and 8% of EU food exports to the world. This figure dropped more than 20% in one year due to the worsening of EU-Russian relations, the subsequent sanctions war and the drop in demand in Russia, and some sources suggested it could cause damage to the economies of the EU countries. WIFO (wifo.ac.at) claims in an article "Disputed trade relations between the EU and Russia" that the current decrease in trade turnover and tourist flows can in the long run cause an increase in overall unemployment of up to 1% of workforce, and up to 0.8% decrease in GDP in the EU.

The reality, however, is that such effects are not likely to materialize even partly. The scale of the problem is too small compared with the adaptive resources of the European economy. On top of that, substitutional effects have already taken place. Despite sanctions and countersanctions, the production of most of the sanctioned products in the EU is increasing because of the overall increase in demand in the world. While Russia is not being able to substitute sanctioned goods with domestic production, it simply buys them from new suppliers (Turkey substituted for Greece, then Chile substituted for Turkey, the Faroe Islands substituted for Norway, Tunisia substituted for France, Belarus for Poland, etc.), causing both the redistribution of flows and black market intermediation by quite a few countries, which are now making a good deal of money by affixing new labels on sanctioned goods and then smuggling them into Russia. To compensate for losses in those smaller product lines where the sanctions were really sensitive for particular businesses, local governments and EU authorities stepped in to provide financial aid and purchase excess production, redirecting it for charity.

In this regard, a Polish story of apples exports is both typical and enlightening. Poland was the biggest supplier of apples, with over 55% per cent of the crop going to Russia. After the Russian sanctions were imposed, many farmers in Poland began to panic, causing applie prices in Europe to drop and the margins of those selling during the season to halve. The rebound, however, was quick: those who stored apples until winter lost little in price and sold almost 100% of the harvest. Serbia and Belarus took an active part: for as little as €500 per truck, the delivery's documentation would be changed. The government stepped in and bought 15% of "should have been sold to Russia" apples. Canada, UAE, Hong Kong and other countries started to buy Polish apples. Eventually, the overall food exports of Poland rose by 4.5% in 2014 and preliminary estimations indicate there was a further increase of 8% in 2015—altogether 3 times the overall food export from Poland to Russia before sanctions.

Russia, in turn, experienced a short-term growth of agricultural production (overall reaching a cumulative growth of about 8% over 3 years), which coincided with antisanctions, a sharp devaluation of the ruble that made domestic production much more competitive, and good harvests in 2015 and 2016. 2015 was also a year of substantial domestic investment in the agricultural infrastructure in Russia, made mostly by the government with funds borrowed from the state agricultural bank at a discounted rate. This growth appears to be unstable, however, and 2017 brought a noticeable decrease in the growth rate as new investments vanished, leaving Russia with an insignificant achievement in the area, not exceeding 0.2% of total GDP.

Global changes in tourist flows seemed to help the European tourist industry regain revenues from lost Russian tourists. The short-term contraction in tourist flows to Europe because of the sharp decrease in households earnings in Russia was followed by the fall of the euro-dollar exchange rate and political and security problems with two major tourist alternatives, Egypt and Turkey. During the 2016 season there was a partial return of pre-crisis numbers of Russian tourists to EU resorts, and in 2017 Russian tourists, attracted by the rebounded ruble, flooded European resorts, especially Cyprus and Greece.

Russian Prospects: Gloomy Perspectives for Change

Since 2000, Russia has experienced two well-known interconnected phenomena: a classical commodities boom and a serious case of Dutch disease, in which over-reliance on energy exports has badly damaged and distorted the economy as a whole.

The rapid rise in oil prices at the start of the century dramatically boosted state revenues and relieved the government of the need to both broaden its tax base and spend more efficiently. In addition, because the state captured the lion's share of oil revenues due to the peculiarities of Russia's taxation regime and distribution of major assets, it was able to consolidate its control over the energy and banking industries and therefore the entire economic and political life of the country. This hampered the development of non-oil-related businesses and made economic and budgetary decision-making much less effective.

By 2008, hydrocarbon export revenues effectively comprised 65–70% of Russia's budget directly or indirectly, according to the calculations made by the Carnegie Moscow Center. There is a 90-95% correlation between the levels of GDP growth, federal budget revenues, and reserves on the one hand and changes in oil prices on the other hand—proof of the extremely tight relationship between hard currency inflows generated by oil exports and the country's overall economic realities. It was no surprise that the massive influx of petrodollars significantly distorted the ruble market exchange rate, which at peak times exceeded the inflation-adjusted rate by more than 35%.

In its effort to control financial flows, the regime deliberately made the investment climate worse by refusing to protect the rights of investors and entrepreneurs. This led to a decline in investment, further distortions in exchange rates, lower entrepreneurial activity, and ever-increasing financial and human capital losses. Capital flight amounted to over $1 trillion during this period, and many of the best business people and professionals left the country.

The copy-paste from the old Chilean copper reserve fund policy by the Russian finance ministry, depositing extra profits into reserves while also borrowing extensively in international markets at a significant spread, together with high risks associated with domestic investing, led to a disproportionate increase in the price of debt capital. That made investments even less attractive and held back the development of capital-intensive and slow-growing sectors of the economy.

The combination of an overvalued ruble and populist government policies (e.g., unjustified wage increases and higher taxes) drastically increased production costs and made domestic production a losing proposition.

In the end, all sectors of the Russian economy suffered. The manufacturing sector never became competitive, despite overall higher revenues fueled by hydrocarbon exports and greater-than-anticipated consumption growth. Hydrocarbon extraction constituted up to 20% of Russia's GDP. In 2014, another 29% came from trade, according to Rosstat.This was a disproportionately high number inflated by the enormous influx of petrodollars, a figure that twice exceeds the average in most developed countries.

Rosstat reprts that the domestic energy market and infrastructure comprise another 15% of Russia's GDP. Public projects make up a further 15%, while the financial sector accounts for almost 10%, which means that about 10% of the country's GDP comes from the independent service sector and non-resource production.

On top of this has come a decidedly unreasonable social policy. Personal incomes have outstripped GDP growth even when the oil factor is taken into account. The public sector employs 30% of the workforce directly and another 8% indirectly, thus shouldering an excessive burden. Half-hearted and indecisive government policies have led to the failure of pension reforms (and Russia had at least 3 of them in the last 20 years). The federal budget was further overloaded by ambitious but inefficient projects and inflated defense and security spending. Finally, massive corruption blew budget spending out of proportion.

As oil prices declined, Russia was stuck with an undiversified, quasi-monopolized economy lacking the resources to stimulate growth. The desolate landscape observed today is the result of a situation that long predates the current stagnation. It reflects years of chronic failure to adapt to changes in the global economy.

Russia's industrial production capacity has a long history of underinvestment. Utilization of production capacity is nearly 85%, even at the currently modest levels of output. But a large part of Russia's production capacity (more than 40%, according to some estimates) is technologically and functionally obsolete. Many Russian-made products cannot compete in the world market, mostly because of the technological gaps and inefficiency of industrial equipment.

One reason for the decline is that the total machinery stock in Russia has shrunk by almost half over the past ten years, a problem that can only partly be explained by old, inefficient machinery being replaced by new high-tech and more productive equipment. A new spurt of economic growth requires accelerated capitalization of production and the creation of new capacity, but this is something that Russia simply cannot afford.

In 2015 the budget deficit exceeded 4% of GDP, and the government then adopted a 3-year budget plan that provided for a GDP deficit of 3% for the next year. State budgets shrank in real terms almost to half of the size of those 5-6 years earlier, and state financing of the economy was planned to shrink 20% more over the ensuing three years. Only recently did the government take into account the rebound of oil prices, which has led it to revise its forecast, suggesting that the budget deficit will decline to 2% of GDP per year in coming years. Indeed, welfare funds helped Russians to survive during 2014–2016 period, and the remaining funds are slated to be used for the financing of the deficit in years to come, together with an increase of internal debt amounts, which are currently quite low. Still, state companies do not have the funds to catch up on investments, and Russian and foreign private players alike are unwilling to invest because of the overall crisis of confidence in Russia.

Russia has fallen far behind its international peers in efficiency. Russia uses four times as much energy per dollar of GDP as Japan and the cost of transporting, storing, and processing goods through customs is very high by world standards. Moreover, Russia's workforce is shrinking by 0.5% per year. It is concentrated in sectors with very low or nonexistent value added, such as the civil service, law enforcement, private security, retail, agriculture and the highly inefficient banking sector. There is a skills shortage, with a disastrous lack of engineers, technicians, and other skilled workers, not to mention competent managers and administrators.

For years, Russia's municipal services have been maintained through the exploitation of the labor of millions of migrants from neighboring states, most of whom are in Russia illegally. Until recently, cash remittances from these workers were the main source of revenue for Kyrgyzstan, the second-largest source for Tajikistan, and a major component of revenue in Uzbekistan, Moldova, Ukraine, and Belarus.

Today, however, the number of labor migrants is dwindling because of the devaluation of the ruble and the decreased purchasing power of the Russian population. As a result, all businesses that rely on unskilled labor—particularly municipal services, but also the retail sector—are short of workers. Overall, shrinking demand has led to closure of a significant number of outlets and termination of quite a few new construction projects, but the corresponding decrease in demand in the workforce really did not compensate for the outflows of foreign low-skilled labor.

Inconsistent and illogical government policies have exacerbated the situation. The absence of a solid legal framework for property rights, the economy, and entrepreneurship means that investors and businessmen both in Russia and abroad harbor nearly unshakeable impressions that the government is unreliable, unable to enforce laws fairly and consistently, hostile toward the business community, corrupt, and likely to prioritize state interests over private ones.

This lack of trust in the government has converted a growing number of Russian businessmen from skeptics to expats. Over the past 16 years, total capital flight has exceeded total revenues from oil and gas sales. The share of private business in GDP (not counting quasi-private companies effectively owned by individuals working for the state) has fallen to 30–35%. Foreign debt has dropped below 50% of GDP due to lack of interest in maintaining business development and the knock-on effects of divestment by Russian players.

The Russian private sector is so undeveloped that it generates less than $3,000 per year per capita in GDP, a figure that puts Russia outside the top 100 countries worldwide in this ranking. According to official statistics, the proportion of small and medium businesses in GDP was close to 20% in 2014 and was close to 18% in 2016, compared to 40–55% in developed countries. In 2016 over 70,000 small and medium-sized enterprises were closed in Russia, according to the national statistics agency Rosstat. Yet Russian citizens and ex-Russians have bank account deposits totaling more than $1 trillion in banks in Switzerland and other European countries, as well as Hong Kong and Singapore.

That brings us to the brain drain. Although official statistics do not distinguish a prominent professor or a talented manager from a seasonal worker or a crook fleeing from justice where emigration is concerned, indirect estimations suggest that every year since the late 1990s on average about 20,000–30,000 professionals and businessmen leave Russia. The flow increased dramatically in 2012-2013 after the election related protests and subsequent repression, and has remained high ever since. Aggression in Ukraine, continuing deterioration of the economy, and violations of human rights are among the major reasons for emigration, along with such pragmatic reasons as lower tax levels in many European countries, lower cost of doing business, less bureaucratic burden and many fewer personal risks.

Meanwhile, hopes that the devaluation of the ruble may improve Russia's long-term productivity are misguided. Devaluation has certainly helped exporters, expanded the budget, and softened the worst of the economic shock. But it is unlikely to boost GDP growth. Potential GDP growth in Russia depends largely on domestic demand, which is measured in rubles and is basically not growing. Eventually, growth in exports requires capital investment and technologies, neither of which is available at the moment. Moreover, in almost every sector of the Russian economy, production depends to some degree (anywhere from 15-80%) on the import of raw materials, parts, or equipment. The devaluation of the ruble is increasing the ruble-denominated prime cost of goods and even services faster than consumer demand is rising.

The investment and business resources Russia needs for diversification of the economy are not there and will not appear unless and until Russia's governance model undergoes radical change. So far there is no sign of any change in attitude towards reforms by the Kremlin. Indeed, the new reform plans are being produced (recently two of them were ordered and presented to the President by two independent groups—Kudrin's and Titov's—representing the mix of left- and right-liberal economists and more or less state-dependent businessmen), however they are not much different from the plans produced years before, and peacefully buried in multiple committees and commissions without any attempt of even partial implementation. The current situation, as seen from the Kremlin towers, is close to stablilization, the long term GDP growth forecast is in a range from zero to 1% per annum, households incomes almost stopped falling, having found support at about 65% of their 2013 levels, and the government is leery of risking stability for an unclear perspective of any reforms. Sources from the goverment confirm that the general understanding is that due to accumulating problems with infrastructure and the financial system, such stability would not last for longer that 8-10 years from now. Then, every one rightfully concludes that it is far beyond the current government horizon and out of focus.

Approaching a Closer Framework with Russia and its Neighborhood

The European Union is purposefully trying to develop deeper and more efficient trade and production cooperation relations with the markets around it, paying more attention to the potential of those markets than to their current size.

Establishment of rather political bodies like the Euro-Mediterranean Association Agreement or the Union for the Mediterranean, or the Eastern Partnership with its eastern neighbors, was followed by the launch of the Deep and Comprehensive Free Trade Area (a weak form of an old European Free Trade Association and integral part of the European Association Agreement)—in essence a set of bilateral agreements with neighboring states covering trade tariffs, custom operating regulations, sanitary and technical standards, transparency and public procurement issues and other aspects of facilitation and unification of trade and production processes, based on EU standards. So far only three countries—Moldova, Georgia and Ukraine—have signed a DCFTA, and it could have looked like a specific attempt to penetrate the former USSR economic space, however current active negotiations about DCFTAs with Tunisia and Morocco prove that the new form of close economic cooperation proposed by the EU is conceived for broader use.

The EU's attempt to push the borders of the free trade and co-production based on EU standards and regulation faces resistance from the other center of economic gravity concerned with its *Lebensraum* in a contemporary format—the Russian Federation. In parallel with EU activities, Russia has developed a so-called ECU—the Eurasian Customs Union—born in 2010 and having Russia, Kazakhstan, Belarus, and (later) Kirgyzstan and Armenia as participants. Russian authorities put enormous efforts to prevent other former USSR republics and CIS members from associating with the EU in any forms, trying to convince (and even force) them to join the ECU—with success. European Union officials currently consider Russia a threat to their plans and thus are foregoing an opportunity of looking at Russia as yet another potential partner, which, if attracted, may deliver others into the net by virtue of its regional economic dominance. Russia still has a domestic market of over 145 million people, with a Chinese average level of household income and consumption, and (although 1/15th of the EU)—a GDP that is 4 times greater than the combined GDP of all the current DCFTA members and candidate states. The ECU market is too big and too close to be ignored as the EU contemplates wider integration and development.

The differences between the EU and the ECU are not limited to their respective size. While the EU has no dominant economic force (some may argue that Germany pretends to be it, yet its GDP is only 20% of the EU total), Russia represents over 80% of the ECU's GDP and trade. The EU is a well-established political union with fully developed rulebooks and procedures. The ECU pretends to be a political union, however there is no clear political body developing its framework and establishing common rules. Unlike the EU, where there is always a queue of candidate countries willing to get associated or/and become a member, the ECU has no volunteers to join, and Russia has to use a combination of seduction and coercion to try to gain new members. The ECU's external focus is on trade diversion, on protection of the inner producers allowing them to avoid competition and ultimately deteriorating value for end customers. The EU's focus is on free trade expansion. Although the ECU is weaker than the DCFTA (it focuses mostly on establishment of a common custom area, principles and tariffs), it makes its members inflexible enough to be unable to participate in any other significant economic blocs or associations.

There is a chance that closer cooperation between the EU and ECU still may be initiated via through the belt of intermediary states. Successful integration of Ukraine, Georgia and Moldova into the DCFTA framework, and even further inclusion of other non-ECU countries such as Azerbaijan or Uzbekistan, will definitely strengthen the position of the EU towards negotiations with the ECU and Russia.

DCFTA membership does not necessarily prevent countries from trading with the ECU. Nothing in a DCFTA prohibits its members from having specific bilateral agreements with other countries and unions, unless they contradict DCFTA itself. Having said that, ECU members can have bilateral free trade and custom agreements with other countries, however a DCFTA is not viewed as a form of bilateral agreement and we should not expect the EU to agree to treat it as an FTA under any circumstances.

One of big issues standing in the way of the development of EU/DCFTA—ECU cooperation are the technical standards changes imposed by DCFTA. Most newcomers have outdated GOSTs [state standards] as a legacy of the Soviet Union. Russia is also changing its standards base, and as of today almost half of the most-used technical standards in Russia are already compatible with those of the EU. (And in the Ukrainian case, ironically, a big part of trade with Russia is still in military equipment, which is not covered by DCFTA). Eventually, DCFTA does not prohibit imports of goods not matching EU standards, and certainly does not limit members' ability to produce and export non-matching goods to non-EU countries. In that regard, the signing of a DCFTA in and of itself cannot significantly influence the ability to trade; however, the unification of standards that can facilitate the entry of new members' products into the EU market will significantly change trade patterns, and not necessarily in favor of external trade.

A DCFTA is broader than a trade agreement. It requires its members to change a number of fundamental laws, liberalize major service sectors, adopt EU intellectual property rights, thus rendering DCFTA members incompatible and unacceptable for any form of association with the ECU in its current form. Deeper cooperation between the ECU and EU/DCFTA members is hardly possible unless either of them implements serious changes in policy. Recalling the relative weights of the economies of the EU/DAFTA and the ECU, the dependency of the ECU on the European market and the current negative trends in ECU member economies, we may assume that the ECU is the one that will face the need to change if it wants to have closer economic ties with the EU. This is difficult, and raises the fear—expressed by Russia many times—that cheap European goods will flood the ECU market should countries with specific trade agreements with Russia also become members of a DCFTA. This fear is grounded: the accession of Kirgystan, having a specific duty free trade arrangement with China for private traders, immediately led to a massive flow of Chinese goods through this country into Russia.

In light of the situation, EU members, supported by the new associated partners who are seriously interested in retaining economic ties with Russia, should develop and maintain a pragmatic strategy of very slow convergence (not to frighten off the beast)—a sort of the new, more realistic, yet less broad and more gradual Common Economic Space Program (instead of the one put on hold a few years ago). There is also a good chance that the political position of Russia will evolve and become less isolationist as mineral resources play a lesser role in Russian trade and the Russian economy. Unfortunately, the current hostility means that such changes are less likely in the short run.

Future Scenario: Little Change After All?

According to the EU Trade and Investment Strategy approved by the EU Council on November 27, 2015, "The EU's strategic interest remains to achieve closer economic ties with Russia. The prospects for this will, however, be determined primarily by the course of Russia's domestic and foreign policy, which so far gives no signs of necessary changes."

One should doubt the ability of the two partners to seriously improve their cooperation should Russia undergo a magic change and start behaving differently, however, given the failure of all previous attempts to generate substantial improvements during two decades in which a relatively good political atmosphere prevailed. The fact that recent Russian actions in and around Ukraine and massive ideological anti-European pressure on Russian society did not cause serious damage to commercial relations with Europe proves the real unwillingness of the EU to connect commercial issues with political manoeuvres. European countries had all the tools they needed to force Russia to retreat: a ban on supplying of new aircraft, railroad, telecom equipment and spare parts and services; a suspension of operation of banking accounts and legal entities opened by Russian commercial and state bodies; and a declaration of intent to gradually decrease the consumption of Russian gas and oil until all hydrocarbon imports from Russia are halted within five years—these are just three of a handful of measures at the EU's disposal, each of which could make Russia stop.

Taking the above into consideration, we can conclude that commercial relations between the EU and Russia will most likely remain stable for many years, but that their scale will diminish. We can expect a gradual decrease of Russian oil exports and most probably gas exports to the EU; Russian imports from the EU will also fall, simply because economic recession and shrinking exports will limit Russia's ability to buy abroad. Russia is likely to remain unable to diversify and enhance its economy. As currency inflows dry up, Russia will seek to diversify suppliers of essential equipment, and over time will succeed in substituting European higher quality and more expensive machinery and systems for more affordable and often lower quality equipment, whether from China or other countries. Over time, Russia will return, at least partially, to the production of necessary machinery as it did during Soviet times. While today the share of foreign passenger cars sold in Russia exceeds 80% of the total market, and 71% of cars, officially produced in Russia, are in reality foreign cars, assembled on Russian industrial facilities, 25 years ago AvtoVAZ, together with a few other automotive plants, were the only sources of the cars for the internal market.

We may expect that in 10–15 years the EU will become much less dependent on Russia in the field of energy security, and Russia will gain independence from Europe both in financial, industrial and infrastructural spheres, due to a range of circumstances, including growing cooperation between Europe and developing countries from the Middle East, North Africa and the Asia-Pacific region, the development of alternative energy sources and transmission channels, and the steady relative decline of the Russian economy. These processes will take place irrespective of political developments, regardless of whether for example Ukraine will join the EU in any capacity, or, after an unsuccessful attempt to develop a western democracy will rush back to the Russian embrace. Russia will however remain a European neighbor, a large resource-rich country with a poor but relatively wide market of over 140 million people, and a territory, strategically positioned between the EU and the Asia-Pacific region, that makes Russia the permanent reserve transportation channel between the East and the West. Given all of these considerations, trade relations between the EU and Russia, including the extensive trade of services, will remain in place—as will political tensions and bureaucratic declarations about the need to improve cooperation and achieve closer economic ties.