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# Ukraine - Falling Prey to Russian Economic "Colonisation"?

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## ABSTRACT

Ukraine's position in regard to Russia has been shaken further with the conviction of former Prime Minister Yulia Tymoshenko, sentenced to seven years in prison for abuse of power during her appointment as Prime Minister of Ukraine – a decision that was condemned both by Moscow and the European Union. Given that the Kremlin perceives Ukraine as being in Russia's geopolitical sphere, Ukraine harbours concern over its powerful neighbour's growing ascendancy in their economic relations – a bilateral tension that has been illustrated by a hardening in tone by both parties, the outcome of which is still uncertain. This study offers an overview of Russian economic influence in Ukraine beyond the customary theme of the gas sector, and attempts to assess its impact on Ukraine and its relations with the European Union.

At the end of August the message was quite clear: "It seems to me that we have made a clear offer: if you want a gas discount, you must join the integrated zone ...: "[1] Russian President Dmitri Medvedev declared impatiently.

Ukraine finds itself challenged in a relatively typical case of tightrope diplomacy in which it usually tries to negotiate its "political" friendship with Russia in exchange for "discounts" on the purchase of gas. But Kyiv, which has been boosted by its successful entry into the World Trade Organisation, is hesitating over joining the Russian-Kazakh-Belarus Customs Union as requested by Russia. Kyiv hopes for the conclusion of an Association Agreement with the European Union, (which includes the Deep and Comprehensive Free Trade Area agreement, the DCFTA) which would provide a counterweight to Russian power. European leaders have warned that Yulia Tymoshenko's conviction, against the backdrop of a gas import deal with Gazprom, could endanger the future of the association agreement. Moscow believes that there are anti-Russian motives behind this conviction.

Since Viktor Yanukovich took office as Head of the Ukrainian state in January 2010, Russian economic designs in Ukraine have made themselves apparent, both via bilateral institutional vectors (cooperation and integration agreements), and also via direct investments, in terms of which Russia is only in fourth place,[2] but this position is im-

proving[3]. The Russian market is the first outlet for Ukrainian exports[4]. Ukraine imports nearly all of its gas from Russia and also all of its oil products. Ukrainian economist Vasyl Yurchyshin even believes that the Ukrainian economy is unduly vulnerable with regard to the rouble[5]. According to a Russian Foreign Ministry think tank, Russian capital is said to control nearly one third of the Ukrainian economy[6]. But what is the significance of this?

The murkiness of shareholder structures, the use of Cyprus-based shell-companies by a great number of investors in Ukraine, not to mention the effective control exercised over businesses makes any estimate extremely approximate, resulting in a variety of interpretations[7]. Opposition parties in Kyiv are concerned that the Kremlin will implement a "colonisation" strategy or that it will take over control of the Ukrainian economy, with the aim of cultural, political and economic subservience, as part of greater geopolitical domination.

At the same time Russian investors' interest in Ukraine seems to be in line with an entrepreneurial trend: undoubtedly Ukraine is a naturally attractive market for neighbouring capital which is in search of new projects and investments that are, in principle, beneficial to both parties. Moreover there are still a great number of inter-dependent sectors 20 years after Ukraine's independence.

After reviewing the situation from an historic standpoint, this paper offers an overview

1. [http://www.kyivpost.com/news/business/bus\\_general/detail/112063/#ixzz1bP7Ifod](http://www.kyivpost.com/news/business/bus_general/detail/112063/#ixzz1bP7Ifod)

2. <http://www.ukrstat.gov.ua/>  
State Statistics Department,  
July 2011

3. Blyakha, Nataliya *Russian foreign direct investment in Ukraine Turku Pan European Institute 07/09 pp5-6*  
<http://www.tse.fi/FT/yksikot/erillislaitokset/pe/Pages/default.aspx>

4. <http://www.ukrstat.gov.ua/>  
State Statistics Department,  
January-July 2011

5. Yurchyshin, 28.09.2010

6. Sergei Jiltsov, "Rossisko-ukrainskoe sblizhenie ne izmenilo prioritetrov vneshney politiki Ukrainy", *Nezqvisimaya Gazeta*, 06.09.2010.

7. v. Blyakha op. cit. for an estimate

of Russian economic influence in Ukraine beyond the customary theme of the gas sector, in a bid to assess its impact on Ukraine and its relations with the European Union.

## 1. THE HISTORICAL CONTEXT: A DIFFICULT DIVORCE

### The Soviet Legacy: two intertwined and interdependent economies

"Losing Ukraine is tantamount to madness" warned Lenin in 1918 as the Red Army fought to assert its power in Ukraine. From Bismarck to Zbigniew Brzezinski, there has been no end to the aphorisms illustrating the imbrication of the two nations. From an economic point of view, back in the time of the Russian empire, major Ukrainian sugar industrialists, who were sometimes of Cossack descent, were amongst the wealthiest and formed part of the imperial nobility. In the Soviet era the centralised economic system provided the Socialist Republic of Ukraine with a key position in terms of industrial production. In Ukraine, hopes of independence, which spread across the entire Soviet Union in the era of Perestroika, were twofold: cultural and political emancipation on the one hand, and on the other economic freedom from Moscow whose centralizing role was perceived as being exploitative. But Kyiv underestimated the extent to which Russo-Ukrainian production networks overlapped; energy dependency has been a major hindrance to Ukraine's autonomous development and has not been the focus of any strategic reform since 1991. With independence and the collapse of the planned economy Ukraine faced a double crisis: the end of the centralised economy from Moscow and the breakdown of the production chains. In the 1990s the system was based on fixing deals on a day to day basis, with bureaucratic networks looking to develop internationally: Yulia Tymoshenko's activities in "Ukrainski Benzin" are a classic example – she imported Russian oil and petrol to feed the region of Dnepropetrovsk.

Twenty years after the fall of the Soviet Union this interconnection remains vital: rail wagons used in use in Russia are assembled in the Luhanskteplovoz factory in Ukraine and some tubes are only produced in Ukraine and comprise one of the main Ukrainian exports to Russia. Ukraine was home to nearly 40% of the nuclear power stations in the Soviet era and today it exports electricity to Russia, using these same nuclear power stations.

However, the power stations are fired by Russian nuclear fuel (diversification projects are on-going) including uranium, which is extracted in Ukraine. The aircraft manufacturer Antonov assembles its planes in Voronej in Russia, using wings and engines manufactured in Ukraine, which are then exported to Russia. Whilst Ukraine inherited some of the biggest shipyards on the Black Sea, Russia retained the engineers capable of designing ships. And there are many other, similar examples, ranging from aircraft manufacture to arms assembly. Twenty years on, these mutual dependencies have not been untangled, and in fact that process was even never really started. This explains in part Russia's keen interest; since it has not succeeded in developing these sectors from scratch in Russia, Russia feels all the more irritated by the close proximity of its former common property – especially since the strategy of major Russian industries towards vertical integration takes them over the border into Ukraine[8].

### Leonid Kuchma: A quest for Independence but on a Russian lifeline

The Presidency of Leonid Kuchma (1995-2004) took economic relations with Russia into an era of centralised decision-making. A product of the Soviet military-industrial elite, he started political and economic consolidation in order to take control over highly regionalised groups. The import of Russian fuel was negotiated at the highest level but was then left to intermediaries with a virtual monopoly, who had the approval of the highest spheres. Kuchma launched a "multi-vector" policy to accommodate both Western and Eastern expectations, but this often proved contradictory: it aimed to build on joint economic terrain with Russia whilst protecting the Ukrainian economy from Russian oligarchs – sometimes advocating rapprochement, sometimes rejecting Europe.

Kuchma positioned himself as the supreme defender of Ukrainian economic interests and at the same time he gave the green light to dominant Russian participation in the energy sector. The weakness of economic checks and balances and of the regulators left the game in the hands of a single referee between the groups, ie Leonid Kuchma, who was nicknamed by some as "Papa" or the "Guarantor". The entry of Russian oil companies into Ukraine (Lukoil, TNK-BP) started in 1998 and continued until 2004. It reflected "the calculations of former President Kuchma that the Soviet-built infrastructure in Ukraine can work profitably only as part

8. Vahtra Peeter: *Expansion or Exodus? The new leaders among the Russian TNCs*, University of Turku, 2007. p.6 [http://www.tse.fi/FI/yksikot/erillislaitekset/pei/Documents/Julkaisut/Vahtra13\\_07.pdf](http://www.tse.fi/FI/yksikot/erillislaitekset/pei/Documents/Julkaisut/Vahtra13_07.pdf)

of a larger market in the post-Soviet space"[9]; moreover this echoed a belief held by 'red' directors, who were the product of the Soviet industrial elite. This view also falls in line with new ambitions for regional power, even a "liberal empire[10]", that were emerging under the presidency of Russian President Vladimir Putin. The appointment of former Russian Prime Minister and historic boss of Gazprom, Viktor Chernomyrdin, as the Ambassador to Ukraine in 2001 is a good illustration of the new trend in bilateral relations.

Kuchma also initiated the politicisation of economic relations with Russia - negotiations to postpone payment of the gas debt in exchange for political promises, which often remained to no effect - such as making Russian an official language or the delimitation of maritime borders, for example.

### Orange Power (2005-2009): a rise in Russian investments

And so, was it to be Viktor Yushchenko who would break Ukraine away from Russia? It was now the "market" and not policy that would govern economic relations between the two "partners", announced the "Orange" government, which notably committed to paying Russian gas at market price (a promise fulfilled by Prime Minister Yulia Tymoshenko in 2009). But matters were not quite so simple: the euphoria created by the hope of new legal and institutional transparency extended to investors -notably the Russians- who were attracted by a market that was so attractive, but which until now had been the "private domain" of the Ukrainian oligarchs. As of 2005 Russian investors in particular rushed into the telecom sector and metals industry. At the same time the expansion of Russian businesses was not just specific to Ukraine or even to the CIS; it reflected the boom of Russian business worldwide, with the value of direct foreign investments multiplying by ten between 2000 and 2010[11]. Allegedly, Russian businesses were also attracted by the "freer" economic climate in Ukraine[12].

But the commercial component in of these trade relations stopped where gas trade commenced.

In January 2006, Viktor Yushchenko put an end to the first gas crisis by re-introducing a plan to import Russian gas that was criticised for its lack of transparency - i.e. that of employing intermediaries, whose usefulness and role were subsequently deemed dubious. The intermediary, RosUkrEnergo (RUE), is a joint venture between Gazprom (50%) and an Austrian company Centragas, based in Swit-

zerland, whose main shareholder is Ukrainian businessman Dmytro Firtash, who made his fortune by selling goods in exchange for Turkmen gas in the '90's[13]. RosUkrEnergo also gathered strength on the domestic energy market by winning permits to deliver gas to some industrial sectors. RUE only lost its lead position briefly under pressure from Yulia Tymoshenko, who concluded an agreement to import gas directly from Gazprom but at a higher price than previously, a price that rapidly exceeded the market price due to the formula used in the agreement[14].

The cancellation of this agreement is at the heart of Ukrainian government demands, and Yulia Tymoshenko's conviction is seen as leading to this. Many experts have noted however that the 2009 agreement does include a re-negotiation clause which enables Ukraine to decline talks of a political nature[15]. This clause is said to be similar to those included in Gazprom contracts with other purchasers such as Edison (Italy), and DEPA (Greece), who negotiated lower prices or EON Ruhrgas (Germany) which initiated arbitration.

## 2. RUSSIAN ECONOMIC INFLUENCE BEYOND THE GAS WARS

With the threat of cuts in gas supplies to Western clients in January 2006 the gas wars that were started over the conditions of transit and the purchase of gas by Ukraine dominated thought about Ukraine's dependency. But the political effects of the interdependency of the two economies transcend mere questions of gas transit.

### Government projects: integrationist discourse in Kyiv and Moscow

The Kharkiv Agreements of 21st April 2010 between the Russian and Ukrainian Presidents over the extension of the lease of the Black Sea Fleet in Sebastopol until 2042, in "exchange" for a discount on the price of gas until 2019, was decried as an act of treason by the opposition. But the visit of Russian Prime Minister Vladimir Putin to Kyiv heralded a rapprochement that will possibly be wider and more far reaching: there has been a series of Russo-Ukrainian mergers by way of the creation of mixed capital companies in strategic sectors, notably sectors in which the two countries' economies are still linked - aeronautics, aerospace, shipbuilding, nuclear and the gas sector, with the merger of Gazprom with the Ukrainian state company Naftogaz.

9. Andreas Wenger, Robert Orttung, Jeronim Perovic, *Russian Business Power: The Role of Russian Business in Foreign and Security Relations*, Routledge Transnational Crime and Corruption. 2006 p.9

10. The concept is used by the head of the national electricity monopoly EES Anatoli Chubais in 2003 to describe the mission of Russia, the natural leader in the post-Soviet space. NG 10.01.2003 *Missiya Rossii v XXI veke*

11. In his analysis Vahtra qualifies the high levels of Russian investment as an "anomaly" and questions Russian motives

12. Conference at the Gorchenin, le 23.12.2010: "Russian Business in Ukraine, problems and perspectives"

13. Lazareva A., Guillemolles A. *Une milliardaire ukrainien sort de l'ombre*, *International Politics*, #130, winter 2011

14. For a detailed analysis of the gas agreements and the presence of Gazprom in Ukraine see the report by Mykhailo Gonchar, Alexander Duleba, Oleksandr Malynovskiy *Ukrainian and Slovakia in a post crisis architecture of European energy security* published by the Research Centre of the Slovak Foreign Policy Association <http://www.sfpa.sk/dokumenty/publikacie/329>

15. Gonchar op. cit., *Ukrainianweek*, Oct 7 2011 <http://www.ukrainianweek.com/Economics/32374>

Although both governments have demonstrated their satisfaction with this cooperation, the views of both Kyiv and Moscow remain different. From Moscow's point of view these integration agreements are a response to "economic security threats" defined as of 1996 by the Kremlin as "the need to secure outlets" and the need to give priority to economic relations with "near neighbours"[16]; a concern to guarantee "the reliability" of these outlets in European markets and in those of the CIS are still a priority for the Russian government[17]. The negotiation tactics used by Leonid Kuchma are also reflected in Viktor Yanukovich's approach: political concessions from Kyiv in exchange for economic subsidies, whilst continuing diplomatic contacts with the aim of joining the EU. Moreover, obtaining capital to modernise key industrial sectors is a real concern[18] for a country that is lacking investment.

As of 2011 Russia has found itself with a much less accommodating partner and one that is much less prepared for integration, although it is still thirsty for investment. In the nuclear sector the merger is taking its time, although the Russian company TVEL has beaten Westinghouse and won a tender for the construction of a nuclear fuel production plant. In addition to this the Ukrainian government has encouraged the diversification of nuclear fuel resources in a new "nuclear code" submitted to Parliament, and has also approved (after many years) loading Westinghouse nuclear fuel. In the aeronautic sector the merger would appear to be a simple one – only affecting the service companies and not the production units as far as the Ukrainians are concerned. Criticised when they were concluded, as the beginning of the end of Ukrainian independence, these agreements are only being loosely implemented. There remains the project to merge the gas sector, which the Ukrainian government is fighting since it fears an asymmetric merger in which it would be the loser.

### Big Russian Business in Ukraine: Kremlin's Tool?

Recent analyses of Russia's use of its economic power as a political tool make a distinction between the energy sector, which is highly politicised, and others[19]. This distinction seems mainly to apply to Ukraine.

After Viktor Yanukovich's election the press forecast an imminent "breakthrough" by the Russian oligarchs in Ukraine[20]. Eighteen months later, the picture is a little more mitigated. Whilst the

gas sector in Ukraine is the focus of control bids via entrepreneurs reputed to be close to the Kremlin, others, notably industrial sectors in the east, are successfully resisting Russian advances.

The extent of Russian influence is illustrated by the media: there is the Donetsk clan embodied by Rinat Akhmetov, head of an industrial empire that was born in the East, but which is spreading across the entire country, thanks to his close relations to those in power; then there is the gas intermediary Dmytro Firtash, who has become one of the most influential businessmen in Ukraine. Both men have seen their assets mushroom under Yanukovich. But whilst Akhmetov is portrayed as doing everything possible to defend his interests against Russian advances, Firtash can't rid himself of the shadow of Gazprom on behalf of which he is said to be acting as a sort of "influence broker", according to observers in Kyiv and Moscow[21], though evidence of this appears circumstantial.

### Is Gazprom advancing under the cover of economic agents?

The effects of an asymmetrical merger between Naftogaz and Gazprom on the transit of gas are at the heart of the present Russo-Ukrainian gas crisis. But a merger like this would also facilitate a take-over of the entire domestic gas distribution system: the gas pipeline transit and distribution network, the gas storage facilities (extremely valuable in managing export requests), and distribution companies. Indeed Gazprom would be in a position to take direct control of the gas supply companies in Ukraine, the oblgaz, which are vital links in the acquisition and distribution of gas, by means of a merger of its energy assets with those of Renova, the industrial empire owned by Russian oligarch Viktor Vekselberg, who controls five gas distribution companies in Eastern Ukraine. Moreover observers highlight the recent success of Ukrainian oligarch Dmytro Firtash, whose business is closely linked to the interests of Gazprom. "Although RosUkrEnergo's and Dmytro Firtashes' offshore companies effectively control two thirds of the Ukrainian oblgaz (...) we can credit Gazprom with the control of 50% of gas distributors" stresses Yuri Korolchuk of the Energy Studies Institute in Kyiv[22].

The recent successes of the DF Group – after the election of Viktor Yanukovich – in two further sectors – the chemical and titanium industries – are contributing to the idea that Russian economic influence[23] is increasing. Thanks to a billion dollar

16. State Economic Security Strategy of the Federation of Russia, on the Presidential decision of Boris Yeltsin, April 1996. <http://www.scrf.gov.ru/documents/15/23.html>

17. Russia's energy strategy until 2030, 13.11.2009, decree #1715-p

18. Kommersant-Ukraine 6 September 2011. Yanukovich; Kommersant 04.08.2011 on the need to attract foreign investments including from Russia.

19. Wenger, op. cit. p.7

20. [http://www.ng.ru/cis/2010-07-22/100\\_posol.html](http://www.ng.ru/cis/2010-07-22/100_posol.html)

21. See quote by Russian energy expert Konstantin Simonov on the economic information site [ubr.ua](http://ubr.ua) le 6.05.2011. The correspondent of the daily Libération in Kyiv qualifies ROsUkrEnergo as Gazprom's "Trojan Horse" Rosukrenerg, relais opaque de Moscou en Ukraine, 19.01.2009

22. Kyiv Post, 12.07.2011

23. Conference at the Gorchenin Institute op. cit.,

loan granted by Gazprombank, Dmytro Firtash's group (DF group) seems to be aiming for a monopoly of the fertiliser sector via the successive take-over of the main Ukrainian manufacturers (contracts approved by the Anti-Trust Committee) to which assets in Tajikistan, Italy and Germany might be added[24]. The purchase – made public by Firtash – of the port of Nika-Tera on the Black Sea also gives him direct access to the export of fertilisers[25]. With strong support from those in office he is also in a position of strength in the titanium sector, a mineral whose corrosion-resistant, lightweight alloys are used extensively in industry and of which Ukraine is one of the world's leading manufacturers.

Some believe that the agreement between Moscow and Firtash in the business sector will lead to pro-Russian political influence. Experts of the Ukrainian market tend to tone the use of the word "agent", stating that there is a "convergence of opportunist interests rather than a stable alliance within a real strategy of influence."

#### Finance: the search for new markets or an invisible Russian hand?

The presence of Russian investors in the banking and financial sector is impressive: the two (small) stock exchanges in Ukraine – PFTS and Ukrainska Birzha – belong to the RTS Moscow exchange, 10% of the Ukrainian banking sector is said to be held by the Russians[26], either through the purchase of Ukrainian banks (Prominvestbank), or via the establishment of Ukrainian subsidiaries (VTB, Sberbank, Alfa). In 2009, the Ukrainian National Bank announced protectionist measures to prevent penetration by the Russian State bank Sberbank into Ukraine – since it makes no secret of the fact that it is attracted by the Ukrainian market[27].

Moreover there has been a trend for major Ukrainian companies to contract debts (the railway, road building company, energy companies) with Russian state banks (Sberbank and VTB) which benefit from the solid backing of the Russian state. Although the interest of Russian banks is presented as being purely commercial in nature, the potential influence that Ukrainian debt represents has to be taken into account. Another means for applying financial pressure at government level lies in the Ukrainian State's debt with regard to the Russian State bank VTB; it totals 2 billion \$ and is due at the end of 2011. Until now the end date has been extended almost automatically but the risk that a further extension may be granted conditionally cannot be ruled out, says economist Vasyl Yurychkin[28].

### 3. THE LIMITS OF RUSSIAN INFLUENCE

#### Attempts at industrial penetration fail in the face of powerful Ukrainian oligarchs

The metals industry, Ukraine's main export sector (47% of its GNP)[29], is one of the pillars of the economy. It is also an attractive sector for Russian capital that is often on the lookout for an early opportunity; and this undoubtedly coincides with the Kremlin's geopolitical concerns. A first breakthrough into the market after 2005 (Severstal – Alexei Mordashov in 2007, Rusal – Oleg Deripaska in 2008) did not lead to a major take-over in respect to market share. A second wave came after the election of Viktor Yanukovich, which led to warnings in the media against Ukraine being "sold out" to the Russians: firstly by the sale of Donetsk IUD to an anonymous group of Russian investors represented by the VTB bank, and then the purchase of Zaporizhstal by the Russian oligarch Oleg Deripaska, who won a call for tender against Rinat Akhmetov, and finally the daily rumours of the imminent sale of other sectors. However the Russian advance was rapidly brought to a halt: Akhmetov launched a legal contra-attack and recovered Zaporizhstal in September 2011, whilst the IUD barely consolidated its assets.

#### Economic Relations with the European Union

In the past the EU expressed its position clearly, stating that stabilisation in Russo-Ukrainian relations was vital for a pan-European zone. Moreover the stabilising effect of economic relations – noted in Russo-European relations – is missing from energy relations in the former Soviet area because of the asymmetrical balance of power between Russia and its Ukrainian and Belarus partners[30]. Russian influence would therefore be somewhat destabilising. As a result, "with the prospect of a possible rise in Russian influence in certain sectors and in the context of the interdependence of the two economies, the association agreement and that of free-trade are a vital support base" to guarantee Ukraine economic development across the European zone, says one European diplomatic source in Kyiv. The DCFTA would be supported by the Ukrainian oligarchs, not for trade reasons, since WTO membership has opened the markets up adequately, but as a protection to keep Russian economic pressure at bay, to which they would otherwise be subject[31]. However some Ukrainian industry bosses, notably in mechanical engineering[32], who are extremely dependent on outlets in Russia, are against it.

24. <http://www.groupdf.com>

25. *Kommersant Ukraine* 29/09/2011

26. <http://delo.ua/finance/nbu-pochti-10-bankovskoj-sist-161641/>, 11 July 2011

27. *President of the Sberbank German Gref at the Skovoroda Club.* [www.skovoroda.com.ua](http://www.skovoroda.com.ua)

28. *op.cit.*

29. <http://www.ukrstat.gov.ua/> One third of Ukrainian exports in value I (2011)

30. *Wenger, op.cit. p.17*

31; *Eastweek* 14/09/2011 "How Ukrainian Oligarchs view economic integration with the EU and Russia" <http://www.osw.waw.pl/en/publikacje/eastweek/201109>

32. <http://www.pravda.com.ua>, 29.09.2011 Boguslaev, Viatcheslav: "there are two Ukraines: one which works and the other which is partying and wants to flee to Europe."

33. See for example the World Bank's data aimed at the businesses hoping to work in Ukraine <http://www.doingbusiness.org/data/exploreconomies/ukraine>, the international ranking in governance puts Ukraine systematically in the lower third <http://info.worldbank.org/governance/wgi>

## CONCLUSION

In conclusion we should remember that the dangers associated with rising Russian political influence over the Ukrainian economy is rather more the result of the interconnection of the unreformed Soviet era production networks, rather than any real "colonisation" bid. Estimates of Russian economic influence – which is difficult to quantify – tend to be used to serve political stances. But its increase in the domestic gas sector in Ukraine naturally has an effect. Ukrainian debt – either State or business – can also be said to be a weak point. The vulnerability of the regulatory bodies governing economic and trade relations[33] (courts, an-

ti-trust committee, committees delivering permits etc ...) to corruption and cronyism makes them more vulnerable to manipulation for political or mercantilist reasons.

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