WHY RUSSIA'S ECONOMIC LEVERAGE IS DECLINING

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On the cover: Constructing natural gas line in winter, Finland. © Gasum Oy/Jukka Isokoski

Why Russia's Economic Leverage is Declining

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Executive Summary

Despite the Kremlin's desire to reassert influence over its neighbors, Russia's economic leverage in Eastern Europe is declining. After more than a decade of using trade and energy cutoffs to pressure its neighbors to accept its political aims, the Kremlin's tools of economic coercion are losing their effectiveness.

On the energy front, two factors are limiting Russia's ability to use gas as a political bargaining chip. First, the decline in oil prices and the global glut in natural gas production has caused energy prices to fall across Europe. This weakens the appeal of Russian offers of cheaper gas in exchange for political concessions. Second, Russian threats to cut gas supply to countries such as Ukraine are far less credible today. Better EU regulation combined with new energy infrastructure, such as interconnectors and liquefied natural gas facilities, are pushing Europe toward a more liquid and transparent gas market. These changes have reduced the role politics plays in Europe's energy sector, guaranteeing that Russia will remain a gas supplier, which Europe needs, but limiting the Kremlin's ability to subvert market rules.

In the trade of non-energy goods, too, Russia's ability to use threats of sanctions and boycotts against neighbors is declining. In the past, Russia imposed sanctions on countries such as Georgia, Ukraine, and Moldova when they deviated from the Kremlin's foreign policy line. Many such aggressive trade policies are still in place, but their efficacy in achieving their political goals has declined over time, and is likely to continue to do so. One reason is that non-Russian markets — not only the European Union, but also the Middle East and China — are becoming more important trading partners. A second reason is that producers in vulnerable Eastern European countries have learned to diversify away from reliance on Russian customers. The net effect is that Russia is now far less able to use trade sanctions to coerce its neighbors because its importance as an export market continues to decline.

The deterioration of Russia's economic leverage is particularly important for the contested countries between the EU and Russia, notably Ukraine, Moldova, and Georgia. These countries are less at risk to Russian economic pressure today than a decade ago. Continuing to aid them in diversifying their energy supply and trade partners will help further limit the Kremlin's ability to meddle in its neighbors' affairs using tools of economic coercion.

1 Introduction

After two years of military adventurism in Ukraine, Russia is shifting toward using energy and economic levers to achieve its political goals in Europe. The Kremlin has a long history of deploying trade sanctions, energy deals, migration bans, and corrupt gas contracts as tools for advancing its political agenda with the European Union and in post-Soviet countries such as Ukraine, Georgia, and Moldova. In the past, these methods have often succeeded in achieving Russian goals, with far less blowback than the Kremlin's military actions in Georgia and Ukraine.

Yet the reality is that Russia's ability to use energy and trade as levers of political coercion is far less powerful today than it was a decade ago, for two main reasons. First, the combination of new EU energy regulation and the global glut in gas supplies has helped make European gas markets far more competitive. This has reduced Russia's ability to use subsidized gas prices as a carrot or the threat of energy cutoffs as a stick to achieve its foreign policy goals. Second, in large part because of recent sanctions, Russia's trade with neighbors such as Ukraine and Moldova has fallen sharply. In the past, the Kremlin regularly used trade cutoffs to pressure other governments on political matters. But Russia's significance as an export market for its neighbors is receding. As trade volumes fall, the political utility of new Kremlin trade threats is declining. The combination of these factors means that Russia's ability to use economic tools to coerce countries in Eastern Europe is weaker now than at any point in the past decade.

None of this is to advise complacency. The right conclusion to draw is that the West's moves to insulate itself and its neighbors from Russia's ability to deploy economic and energy pressure are working. European Union legislation to liberalize gas markets, for example, has reduced Gazprom's clout and the Kremlin's ability to use pipelines as a political tool. Investment in new gas infrastructure is costly, but it has diversified gas supply to countries that previously depended almost entirely on Russia. In trade, too, Russia's ability to impose trade sanctions on countries that do not follow its political line is decreasing. The EU's decision to further open its markets to countries such as Ukraine, Georgia, and Moldova just as Russia was imposing sanctions on them will reduce the Kremlin's influence and increase Europe's.

The combination of the oil slump, the Kremlin's trade sanctions on its neighbors, and Russia's own economic problems have led many commentators to note that Russia is now "deglobalizing," as its financial, trade, educational, and personal connections with the outside world decline.[1] The isolation of Russia is not, on the whole, a trend to be welcomed, given the painful cost it imposes on Russians themselves. But an era of Russian economic weakness and cheap energy is the best time for the West to set clear rules for future interaction. Many of the economic tools the Kremlin used for purposes of political coercion are far less powerful today than a decade ago. The more the West does to ensure that markets are competitive and transparent, the more it will succeed in separating business from politics in relations with Russia.

The reality is that Russia's ability to use energy and trade as levers of political coercion is far less powerful today than it was a decade ago.

[1] S. Guriev, "Deglobalizing Russia," Carnegie Endowment for International Peace, December 16, 2015, http://carnegieendowment.org/2015/12/16/deglobalizing-russia/in6c; N. Gould-Davies, "Russia's Sovereign Globalization," Chatham House, January 6, 2016, https://www.chathamhouse.org/publication/russias-sovereign-globalization-rise-fall-and-future.

2 The End of the Energy Weapon

Even as Russia uses the prospect of cheap gas to attract "friends," the Kremlin has employed the threat of gas cutoffs to discipline its opponents. Many in Europe fear that Russia might suspend gas supply during the cold winter months, leaving customers without the gas they need to heat homes and power factories.

Russia's vast supplies of oil and gas have long been seen as a "weapon" — a Kremlin tool that could be used to buy friends or threaten enemies. Yet the combination of gas oversupply and new European Union regulation have significantly weakened Russia's ability to use energy as a political tool. This represents a significant change from just a few years ago. Across Europe, the Kremlin has offered discounts on gas to governments that follow Russia's foreign policy line. In 2010, for example, Russia convinced Ukraine's then-President Viktor Yanukovych to extend the lease on Russia's Black Sea Fleet headquarters in Crimea for 25 years in exchange for a sizeable discount on the import price of Russian gas. The prospect of Russian pipeline deals or cheap Russian gas has encouraged many other European politicians to adopt relatively pro-Kremlin positions.

Even as Russia uses the prospect of cheap gas to attract "friends," the Kremlin has employed the threat of gas cutoffs to discipline its opponents. Many in Europe fear that Russia might suspend gas supply during the cold winter months, leaving customers without the gas they need to heat homes and power factories. Given that Russia is the dominant supplier to many countries, this fear is understandable. Belarus, Estonia, Lithuania, and Latvia, for example, long imported 100 percent of their gas from Russia. Russia had dominant position in many other Central and Eastern European countries, including a 90 percent market share in Bulgaria and well over half in Hungary, Slovakia, the Czech Republic, Poland, and Ukraine.[2] If Moscow shut down gas pipelines in the winter, these countries feared they would freeze.

Russia has in fact carried out threats to cut off gas supply, actions targeted mainly at Ukraine. These supply cuts affected an array of countries who received Russian gas shipped via pipelines that transited Ukraine. The most damaging instance was in January 2009, when Russia suspended gas deliveries to Ukraine over payment disputes. Other downstream countries faced supply cuts, too. Some Bulgarian factories had to shut production, while Slovakia declared a state of emergency to deal with deficits in gas for heating.[3]

The greatest victim of Russian gas policies, however, was Ukraine. The country benefited from lower prices than some of its neighbors. But part of the cost was to empower a class of oligarchs who did the bidding of both the Russian government and corrupt Russian officials in Ukraine's politics. One investigation, for example, found that Dmitry Firtash, a Ukrainian oligarch with close ties to Gazprom and the Kremlin, was given $3 billion via corrupt gas contracts — money that was partly used to fund pro-Russian political forces in Ukraine.[4]

The efficacy of Russia's "energy weapon" was often exaggerated, as gas exports were more often used to enrich corrupt Russians than to obtain coherent geopolitical goals. But Russia's use of non-transparent pricing and contract mechanisms fed corruption across Europe, most notably in Ukraine. At the same time, new trends in Europe's gas market are eroding Gazprom's monopolies and forcing it to move away from secret, long-term, fixed-price contracts, and toward competitive market mechanisms. The point is not that Europe is becoming independent of Russian gas — import levels are not significantly changed from a decade ago — but that the energy trade is finally taking place under regulation that promotes transparency

[2] W. Qui, "Russia's Gas Monopoly is Over," *Moscow Times,* October 20, 2014, http://www.themoscowtimes.com/opinion/article/russia-s-gas-monopoly-is-over/509740.html.

[3] V. Toshkov, "Bulgaria Risks Running Out of Gas Reserves," *Fox News,* January 14, 2009, http://www.foxnews.com/printer_friendly_wires/2009Jan14/0,4675,EUBulgariaGas,00.html.

[4] S. Grey et. al., "Special Report: Putin's Allies Channeled Billions to Ukraine," *Reuters,* November 26, 2014, http://www.reuters.com/article/russia-capitalism-gas-special-report-pix-idUSL3N0TF4QD20141126.

and competition.[5] If these changes are brought to completion, gas exports will be transformed from a subject of political negotiation to a straightforward commercial matter.

There are two main forces at work. First, the world is structurally oversupplied with energy. Oil and gas prices have collapsed, with oil now trading at one-third of its price two years ago. A number of factors have driven this shift, from technological changes such as the rise of fracking in the United States, to China's economic slowdown, which reduced future expected energy demand, to buoyant supplies of liquefied natural gas in places as far away as Australia. Abundant supply makes it easier for European countries to import gas from non-Russian sources. And the fiscal pressure that low prices place on Russia make it less likely that Moscow will tolerate the economic pain of gas cutoffs in the first place.

On top of the supply glut, new infrastructure is reshaping Europe's gas market. Unlike oil, transporting gas requires complicated infrastructure. Oil can be moved by train, truck, or ship, but most gas is transported via pipelines. Oil produced in, say, Nigeria, can be sold just as easily in Japan as in the United States with only marginally different transport costs. But reliance on pipelines makes the gas market far less flexible. Eastern European countries inherited pipelines from the Soviet era, which means that they are tied to Russia, and Russia is tied to them. The other main method of supplying natural gas is to liquefy it, allowing it to be transported via ship. This requires special infrastructure, which has historically been more expensive. But new supplies of liquefied natural gas are pushing down the price.

Despite the cost of new infrastructure, some European countries have begun to take seriously the geopolitical ramifications of Russian energy, especially the disparate effects of the Soviet-legacy gas pipeline network. From the Baltics to the Balkans, many countries inherited a pipeline structure that gave them no choice but to buy most of their gas from Russia. Several of these countries have taken significant steps to build new infrastructure and limit their dependence on Russian-supplied pipelines. Lithuania, for example, previously imported all of its gas from Russia and paid one-third more for Russian gas than did Germany. It then spent $128 million building the infrastructure needed to receive liquefied natural gas (LNG). Once Lithuania's LNG infrastructure was online, Gazprom immediately offered sharp price discounts.[6] Now Lithuania can receive gas from suppliers such as Norway or the United States. It can import up to 4 billion cubic meters (bcm) of gas per year, more than enough to meet its entire gas demand and to have some left over to export to neighbors. Gazprom's monopoly in the country has been broken. Russia's ability to use energy as a political tool in Lithuania has declined sharply.

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The most striking change, however, is in Ukraine. Kyiv used to depend heavily on Russia for gas, and suffered the side effects. Corrupt gas deals enriched dubious middlemen, fostered corruption, degraded Ukraine's political system, and — in the case of the deal by which Russia offered discounted gas in exchange for an extension of naval basing rights in Crimea — threatened Ukraine's political independence. No longer. In 2011, Ukraine imported 40 bcm of gas from Russia. In 2015, it imported only 6.1 bcm. Two policy changes —

[5] Online at http://www.gazpromexport.ru/en/statistics/.

[6] M. Seputyte, "Lithuania Grabs LNG in Effort to Curb Russian Dominance," *Bloomberg,* October 27, 2014, http://www.bloomberg.com/news/articles/2014-10-27/lithuania-grabs-lng-in-effort-to-curb-russian-dominance; N. Adomaitis and A. Sytas, "Lithuania Wins Cheaper Russian Gas After LNG Sabre Rattling," *Reuters,* May 8, 2014, http://uk.reuters.com/article/lithuania-gazprom-idUKL6N0NU4CM20140508; *RFE/RL*, "Lithuania Looks to LNG Terminal to Break Russian Monopoly," October 27, 2014, http://www.rferl.org/content/lithuania-looks-to-lng-terminal-to-break-russian-monoply/26659607.html.

Kyiv used to have no choice but to buy the majority of its gas from Russia. Today, however, the European Union supplies more gas to Ukraine than does Russia.

subsidy cuts and supply diversification — explain why Ukraine's import dependence on Russia has declined.[7] These changes suggest that Russia's ability to utilize gas as a political lever in Ukraine has been permanently reduced.

First, consider energy subsidies. For years, Ukraine's government subsidized domestic gas prices. Kyiv bought gas from Russia at high prices, sold it to consumers for low prices, and funded the difference out of the government budget. These subsidies were massive, costing Ukraine over 7 percent of GDP in the years before reforms began.[8] They encouraged wasteful gas consumption. Many Soviet-era apartment buildings blocks had no thermostats for regulating temperatures — why pay to upgrade technology when gas was all but free? When apartments were too hot, millions of Ukrainians responded simply by opening windows. Energy efficiency was unheard of. This government subsidized waste drove up gas import volumes, hobbled the government budget, and encouraged air pollution. But for decades they proved impossible to change, largely because they were a lucrative source of corruption. Buying subsidized gas at home and selling it abroad at much higher market prices using illegally obtained export permits was a profitable business model for various politically connected oligarchs and crime syndicates.[9]

Under pressure from Western donors and the IMF, Ukraine is finally tackling the gas subsidies. Household gas prices were hiked by 285 percent in April 2015, while heating costs were increased by 67 percent. Kyiv is planning to raise gas costs to 75 percent of the import price by 2016 and to completely eliminate subsidies by 2017. Higher costs have already started to reduce consumption by encouraging households and industries to economize. Thanks in part to subsidy cuts, Ukraine's gas consumption fell by 25 percent in 2015.[10] The price hikes will continue to depress consumption over the next several years, reducing Ukraine's overall gas bill. The less gas Ukraine consumes, the less importance gas prices will have to Ukraine's economic success. That will reduce the relevance of gas as a tool in Russian diplomacy.

Even more important than falling consumption is that Ukraine has finally succeeded in diversifying supply. Kyiv used to have no choice but to buy the majority of its gas from Russia. Today, however, the European Union supplies more gas to Ukraine than does Russia. Imports from the EU constituted 10.3 bcm in 2015, compared with 6.1 bcm from Russia. This marks a sharp change from just several years ago. After the post-Maidan government came to power, it immediately began lobbying Europe for "reverse flows" of gas from its neighbors, especially from Slovakia, which has the pipeline capacity to supply a large amount of gas to Ukraine.[11]

Slovakia was reticent to supply Ukraine, fearing that the move would violate secret contracts with Gazprom. As recently as April 2014, Slovak officials were insisting that reverse flows required Gazprom's approval, since it would involve gas originally supplied to Slovakia by Gazprom.[12] But pressure from the European Commission and from Washington encouraged the Slovaks to relent. By

[7] Other factors, such as the decline in industrial production due to economic problems, have also reduced gas demand.

[8] D. Lipton, "The Case for Supporting Ukrainian Economic Reforms," International Monetary Fund, April 7, 2015, https://www.imf.org/external/np/speeches/2015/040715.htm.

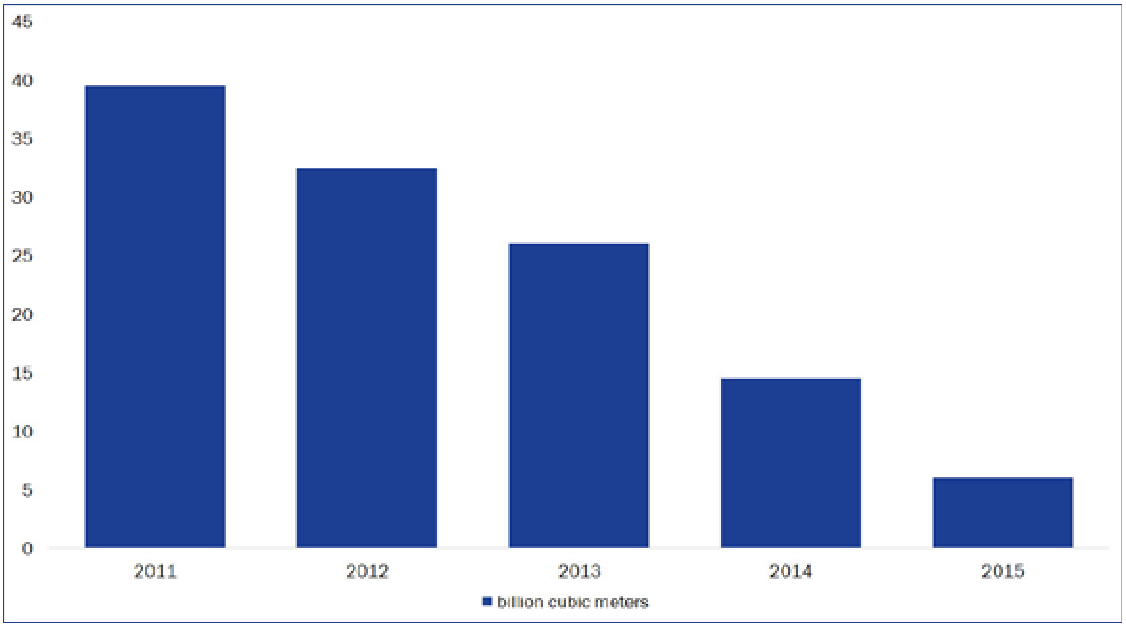
[9] A. Aslund, *Ukraine: What Went Wrong and How to Fix It* (Washington: Peterson Institute, 2015).

[10] *Natural Gas Europe,* "Ukraine Doubled Gas Import from Europe, Halved Import from Russia in 2015," January 8, 2016, http://www.naturalgaseurope.com/ukraine-doubled-gas-import-europe-halved-import-russia-2015.

[11] A. Higgins, "Kiev Struggles to Break Gazprom's Grip on Gas Flow," *The New York Times,* May 5, 2015, http://www.nytimes.com/2014/05/05/world/europe/gazprom-seen-stanching-flow-of-gas-to-ukraine.html?_r=0.

[12] Ibid.

Figure 1: Ukraine's Natural Gas Imports from Russia



Source: Bloomberg

September 2014, significant volumes of gas were flowing from the EU to Ukraine.[13] Over the course of 2014, 5.1 bcm of gas flowed from the EU to Ukraine, bypassing Russian control.[14] Russia agreed to a new gas deal with Ukraine soon afterward, reversing its June decision to cut off supplies to Ukraine, and offering a price below that of the reverse-flow gas.[15]

Gazprom tried to undermine Poland and Slovakia's ability to provide gas to Ukraine using reverse-flow techniques. The Kremlin reduced gas supplies to both countries in September 2014, just as Ukraine

[13] *Deutsche Welle,* "Slovakia Opens Reverse Flow Pipeline to Carry Gas to Ukraine," September 2, 2014, http://www.dw.com/en/slovakia-opens-reverse-flow-pipeline-to-carry-gas-to-ukraine/a-17895333; A. Winning, "Plans for EU Gas Flows to Ukraine Could be Blocked by Russia," *Reuters,* April 7, 2014, http://www.reuters.com/article/ukraine-crisis-gas-idUSL-6N0MZ29U20140407; A. Higgins, "Kiev Struggles to Break Gazprom's Grip on Gas Flow."

[14] M. Grossman, "Ukraine: Europe's Last Gas Frontier," *Natural Gas Europe,* April 28, 2015, http://www.naturalgaseurope.com/ukraine-europes-last-gas-frontier-michael-grossmann-23409.

[15] S. Walker, "Russia Cuts Off Gas Supply to Ukraine After Talks Collapse," *The Guardian,* June 16, 2014, http://www.theguardian.com/world/2014/jun/16/russia-cuts-off-gas-supply-ukraine; *BBC,* "Russia Ukraine Gas Deal Secures EU Winter Supply," October 31, 2014, http://www.bbc.com/news/business-29842505; E. Krukowska and E. Mazevna, "Russia-Ukraine Agreement Cuts Risk of Gas Supply Cutoff," *Bloomberg,* March 2, 2015, http://www.bloomberg.com/news/articles/2015-03-02/russia-ukraine-agreement-cuts-risk-of-gas-supply-cutoff; J. Henderson and T. Mitrovna, "The Political and Commercial Dynamics of Russia's Gas Export Strategy," *Oxford Institute for Energy Studies,* September 2015, http://www.oxfordenergy.org/wpcms/wp-content/uploads/2015/09/NG-102.pdf, p 50.

The Kremlin's attempt to use Gazprom's market power to achieve its commercial and political goals are being further thwarted by the European Union's decision to bring an antitrust case against Gazprom.

was ramping up reverse flow.[16] But Gazprom's efforts failed. Poland and Slovakia were able to buy gas from other suppliers. Gazprom, meanwhile, lost an estimated $5.5 billion in revenue. In March 2015, recognizing its mistake, Gazprom reversed course and began fully delivering Poland and Slovakia's requested supplies, which included gas they intended to sell to Ukraine.[17] Russia achieved to reverse flow only after losing a large sum of money — and after proving that coercive techniques were increasingly less effective in an energy market that was both better integrated and over-supplied.

The Kremlin's attempt to use Gazprom's market power to achieve its commercial and political goals are being further thwarted by the European Union's decision to bring an antitrust case against Gazprom. In April 2015, the EU formally alleged that Gazprom was illegally using its market position to thwart competition and drive up prices. The EU has levied three main claims: 1) Gazprom contracts obstruct the resale of gas and therefore prevent a properly functioning European gas market; 2) Gazprom seeks to prevent the construction of other gas pipelines; and 3) Gazprom overcharges countries that depend on it for gas supply.[18] All three of the EU's allegations against Gazprom relate not only to gas pricing but also to the potential use of gas supply as a political tool. By keeping out rival pipelines, preventing a functioning market, and maintaining its monopoly position, Gazprom increases its profits even as the Kremlin maximizes geopolitical leverage. Gazprom is currently in negotiations with the European Union regarding these antitrust allegations, which it disputes. But even as talks between Brussels and the gas giant continue, shifts in Europe's attitude toward Russia as well as changes in the global energy market are forcing the firm to adjust its strategy in Europe.[19]

On top of these regulatory changes, global energy supply trends are significantly affecting European energy markets. For one thing, the slump in oil prices means that European countries that depend largely on Gazprom for gas supply will soon begin to experience lower prices. The reason is that Gazprom has long insisted on linking gas contracts to oil prices. That benefited the firm when oil prices were high, but it will cut the energy costs of Eastern European countries so long as oil prices remain low. In 2012, Gazprom's average price for gas sold outside of the former USSR was over $400 per thousand cubic meters. In 2015, according to well-informed estimates, the average gas price was probably below $250 per thousand cubic meters. 2016 prices will be lower still.

Second, a surge of investment in liquefied natural gas infrastructure in places as far away as the United States and Australia will depress gas prices in Europe over the next several years. Liquefied natural gas may not play a dominant role in European energy markets for decades, but the increasing supply of LNG worldwide will put a ceiling on the price Gazprom can charge in Europe. If Gazprom tries to charge high prices, Europe will always have the choice of importing LNG from other regions. Indeed, some estimates suggest that the threat of North American LNG supplies will cap the price Gazprom can charge at barely higher

[16] M. Strzelecki and M. Martewicz, "Gazprom Limits Polish Gas Supplies as Reverse Flows Halt," *Bloomberg,* September 10, 2014, http://www.bloomberg.com/news/articles/2014-09-10/poland-says-gazprom-cut-gas-supplies-via-belarus-ukraine; E. Mazneva, "Gazprom is Losing its Market Muscle," *Bloomberg*, December 23, 2015, http://www.bloomberg.com/news/articles/2015-12-23/gazprom-is-losing-its-market-muscle.

[17] *Interfax,* "Неудачная попытка остановить реверс на Украину стоила "Газпрому" $5 млрд" [The unsuccessful attempt to stop the reverse flow to Ukraine cost Gazprom $5 billion], March 19, 2015, http://www.interfax.ru/business/430933.

[18] P. Spiegel and A. Barker, "Brussels Accuses Gazprom Over Stranglehold," *Financial Times,* April 22, 2015, https://next.ft.com/content/dec104ce-e8d1-11e4-b7e8-00144feab7de#axzz3xR4jOfOf.

[19] Ibid.

than the firm's marginal cost of production.[20] If so, Gazprom may struggle to make much profit at all. That risk is one reason that Gazprom's stock market capitalization has declined from $367 billion in 2008 to one-tenth that figure today. As the firm's monopoly position eroded, so too did the prospects of earning outsized profits.

These global energy shifts are good news for energy importers such as the EU. Russia, meanwhile, has more gas than its customers want. This problem, combined with EU antitrust regulation, is forcing Gazprom to move away from its preference for long-term guaranteed gas purchase contracts, which are often opaque and always less liquid. Unlike oil, which is sold on a spot market and is therefore highly competitive, Europe's gas market has traditionally relied on long-term contracts. But in its push for more competition and transparency, the EU is demanding a spot market for gas pricing. Under pressure from the EU and from changing market conditions, Gazprom held its first gas auction in September 2015.[21] More spot auctions have been held since then. As spot auctions spread, they will help create a more liquid gas market in Europe. That means more price transparency and more supply flexibility.

For countries fearing the geopolitical effects of energy dependence on Russia, a truly competitive energy market across Eastern and Central Europe would mark a significant success. Thanks both to the supply glut and to intelligent European Union energy policy, Gazprom's market power is likely to continue to decline. Reliant on European markets, without the ability to restrict the resale of its gas, and facing competition from LNG, Gazprom is slowly becoming a price-taker rather than a price-maker. For many countries in Europe's east — and for Ukraine above all — this is a change that could not happen soon enough. Ukraine will likely continue to have public spats with Gazprom over pricing and transit fees. But the bargaining power of all of Gazprom's customers is increasing. Forging an effective European energy market is not only cutting prices, it is significantly reducing Russia's ability to use pipelines for political goals.

For countries fearing the geopolitical effects of energy dependence on Russia, a truly competitive energy market across Eastern and Central Europe would mark a significant success.

[20] J. Henderson and T. Mitrovna, "The Political and Commercial Dynamics of Russia's Gas Export Strategy."

[21] J. Farchy, "Gazprom Bows to Brussels by Holding First European Gas Auction," *Financial Times*, September 7, 2015, https://next.ft.com/content/ad9a8a5e-5556-11e5-8642-453585f2cfcd#axzz3xR4jOfOf.

3 The Decline of the Sanctions Weapon

Imposing trade sanctions is akin to burning a bridge — it is a tool you can only use effectively once. If sanctions succeed in reducing trade volumes between two countries, this makes future sanctions far less painful, because there is less trade to be cut off.

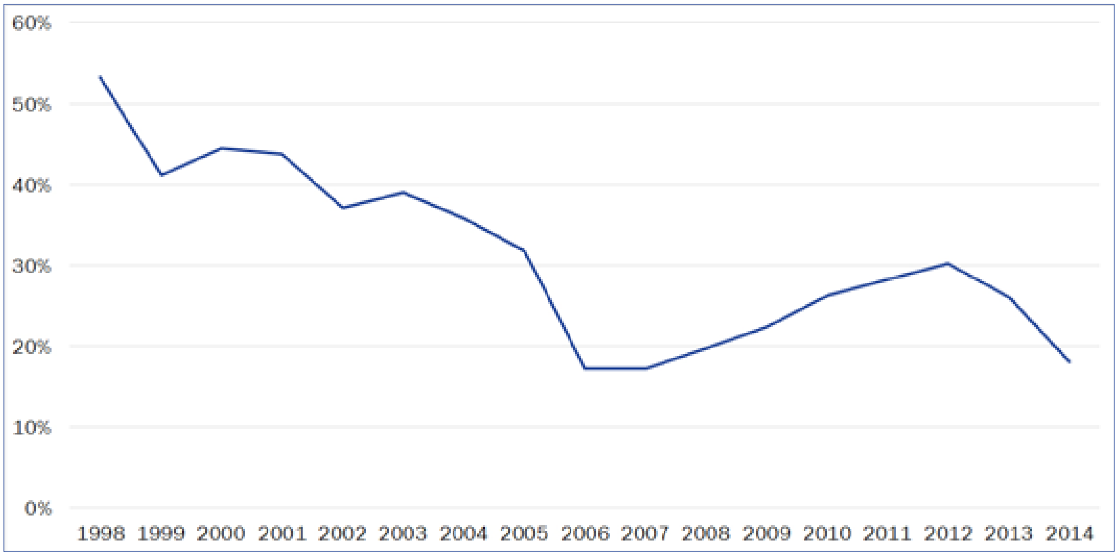
Since the war in Ukraine began, most Western analysis has focused on the financial and energy sectoral sanctions that the United States, EU, and their partners have imposed on Russia. Yet the Kremlin has been a no-less aggressive user of sanctions in recent years. Over the past decade, Russia has imposed politically motivated trade sanctions on nearly all of its neighbors. Some of these measures, such as the prohibition on imports of food products from the European Union, were imposed as a response to Western sanctions. But Russia's most powerful restrictive measures have focused on its neighbors Ukraine, Moldova, and Georgia, which are far more dependent on Russia as an export market than is the EU. All three countries have economies that are far smaller than Russia's; all three used to be heavily dependent on Russia as a source of imports and a market for exports. When Russia imposed trade sanctions, each country suffered significant losses and was forced to redirect trade.

But Russia's ability to use trade sanctions to coerce its neighbors to follow its foreign policy line is decreasing. Before Russia went to war with Ukraine and Georgia, for example, it imposed trade sanctions in an attempt to coerce each country to follow the Kremlin's line. Russia's restrictions on Moldovan wine, to give another example, have caused its tremendous economic pain as a punishment for the country's Western orientation. But whereas Western financial sanctions — and the threat of further measures — may have changed the Kremlin's decision-making, Russia's ability to use sanctions to achieve its political aims is much reduced. The reason is that imposing trade sanctions is akin to burning a bridge — it is a tool you can only use effectively once. If sanctions succeed in reducing trade volumes between two countries, this makes future sanctions far less painful, because there is less trade to be cut off. This is the dilemma that Russia now confronts. It has imposed an array of restrictive measures on trade with its neighbors in an attempt to coerce them to reject closer ties with Europe and to adhere to the Kremlin's priorities instead. These sanctions have caused trade between Russia and its neighbors to plummet. As a result, Eastern European countries now have less at stake in their trade relations with Russia. For countries such as Ukraine or Moldova, the prospect of new Russian trade sanctions is far less threatening than a decade ago.

Georgia suffered from the most aggressive Russian trade sanctions during the 2000s. In 2003, the Rose Revolution brought to power a government that criticized Russia, tried to reestablish control over separatist regions backed by Moscow, and sought to integrate rapidly with the West. In response, the Kremlin imposed a series of economic sanctions on Tbilisi. The conflict began with a steep hike in gas prices, followed by a complete cut off, which forced Georgia to turn to its neighbor Azerbaijan for supplies. Then Russian health inspectors declared Georgian wine — a major export product — unsafe for consumption. A health ban on mineral water, another important export, quickly followed. Trade volumes plummeted. In 2005, before the sanctions, Georgia exported over $150 million worth of products to Russia each year, but that had plummeted to only $20 million by 2009. Thanks to sanctions, Georgia's largest neighbor was consuming only 2 percent of its exports.[22] Since this nadir, improved relations between Moscow and Tbilisi have seen Russia lift some of its restrictive measures, and trade volumes have picked up. But thanks to Russian sanctions, Georgia's exports are far more diversified now than they were a decade ago. If Russia were to threaten new sanctions today, they would be much less disruptive than the trade restrictions of the mid-2000s. Russian sanctions

[22] R.E. Newnham, "Georgia on my mind? Russian sanctions and the end of the 'Rose Revolution,'" *Journal of Eurasian Studies* 6 (2015): 161-170.

Figure 2: Exports to Russia as a Percent of Total Moldovan Exports



Source: World Bank

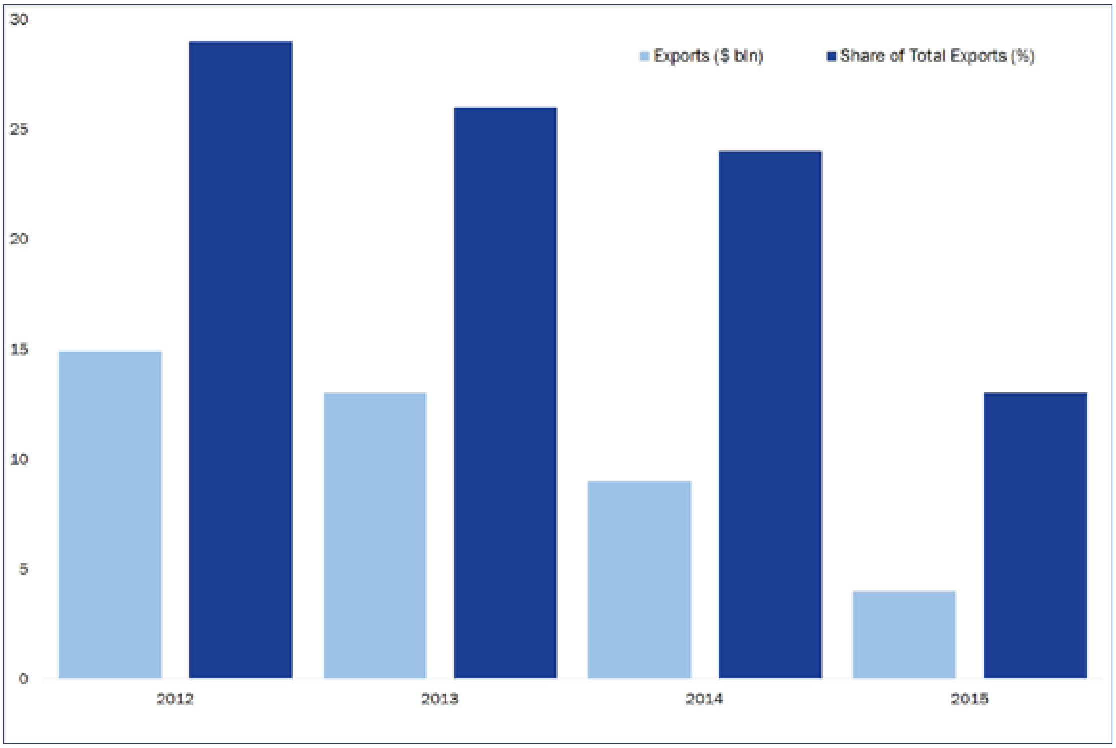
had the counterintuitive effect of reducing the Kremlin's influence.

Moldova's experience has been similar, though the volumes are less dramatic. In 2013, as Moldova prepared to sign an Association Agreement with the European Union at the Vilnius Summit, Russian health inspectors alleged that they found traces of plastic in Moldovan wine and announced a ban on imports. This was not the first time Russia had prohibited Moldovan wine; in 2006, it was also banned for a year. Russia hoped that the economic pressure would "persuade" Moldova that joining the Russian-led Customs Union was a better idea than moving closer to the EU. But here, too, Russian sanctions have reduced the Kremlin's leverage. Before the 2006 wine ban, about 60 percent of wine exports went to Russia. The 2006 sanctions forced Moldovan vineyards to diversify their exports. By 2013, when Russia reimposed sanctions, only one-third of wine exports went to Russia. That made the 2013 sanctions less painful — and less politically effective.[23]

Russia has levied its most significant current trade sanctions against Ukraine. Targeted sanctions against particular industries and individuals have been in place for some time. Russia banned the import of some Ukrainian chocolates, for example, in an attempt to punish Ukrainian President Petro Poroshenko, who owns a large confectionary company. The Kremlin escalated trade sanctions in 2016 by suspending the preferential tariffs of the CIS Free Trade Agreement. Russia took this step in retaliation against Ukraine's decision to sign and implement the Deep and Comprehensive Free Trade Agreement (DCFTA) with the European Union. Russia's decision will increase tariffs on trade between the two countries, reducing trade volumes significantly. Ukraine responded by banning imports of 43 Russian products, including

[23] K. Calus, "Russian Sanctions Against Moldova," Centre for Eastern Studies (OSW), November 6, 2014, http://www.osw.waw.pl/en/publikacje/osw-commentary/2014-11-06/russian-sanctions-against-moldova-minor-effects-major-potential.

Figure 3: Ukraine's Exports to Russia



Source: D. Krasnolutska, "Hidden Sting Drives up Costs for Ukraine in Russian Trade War," Bloomberg, January 14, 2016, http://www.bloomberg.com/news/articles/2016-01-13/hidden-sting-drives-up-costs-for-ukraine-in-russian-trade-war#media-2.

"vodka, beer, cigarettes, meat, chocolates, dairy products, animal food and locomotives."[24] Kyiv estimated that the trade war will cost the country $600 million in 2016.[25]

The problem with trade sanctions is that unless they achieve their political goal and are quickly removed, they can only be used once. If sanctions are only short-term in duration, trade volumes may recover. But if sanctions are in place for a long time, firms will divert business elsewhere. Moldovan and Georgian wines are both good examples. Before the Kremlin's first round of sanctions on Moldovan vineyards, Russia constituted nearly two-thirds of all sales. Thanks in part to the sanctions, that number has declined rapidly. When Russia reintroduced sanctions on Moldovan wine 2013, exports to Russia made up only half the previous amount.[26]

Georgian wine shows similar dynamics. Today, even after Russia lifted sanctions, Georgia now sells half its wine exports in markets other than Russia's, reaching well beyond the former Soviet space;

[24] *Kyiv Post,* "Ukraine launches counterattack on trade war with Russia," December 31, 2015, http://www.kyivpost.com/article/content/business/ukraine-launches-counterattack-in-trade-war-with-russia-405265.html.

[25] *Deutsche Welle,* "Ukraine to Impose Tit for Tat Trade Embargo on Russia," December 24, 2015, http://www.dw.com/en/ukraine-to-impose-tit-for-tat-trade-embargo-on-russia/a-18940722.

[26] T. Dunlop, "Why Russian Wine Ban Is Putting Pressure on Moldova," *BBC,* November 21, 2013, http://www.bbc.co.uk/news/world-europe-24992076.

10 percent is consumed in China.[27] The more sanctions Russia imposes, the more its neighbors will diversify their trade. They have no other choice. And as trade volumes between Russia and its neighbors plummet, the Kremlin is finding that it has ever fewer levers of influence. In Ukraine, exports to Russia in 2015 were only one-third their level of 2012. Trade volumes are falling so rapidly that Russia will soon find it has few products left to ban. And the European Union's decision to open its market to Ukraine, Moldova, and Georgia means that Western partners will play an ever-greater role as export markets for these countries' goods.

[27] *News.Az,* "Georgian Wine Export Decreased by 39% in 2015," January 8, 2016, http://news.az/articles/region/104148.

4 What We Can Do

The combination of energy market shifts and Russia's overzealous use of trade sanctions against its neighbors mean that the Kremlin is far less able to use economic tools to coerce its neighbors than it was five years ago. So long as the European Union continues to promote competition in its energy markets and provide opportunities for Ukraine, Georgia, and Moldova to integrate with European markets, Russia's economic leverage is likely to decline further over the next several years. For countries that have long feared Russia's ability to deploy economic tools to compromise their political autonomy, this is an important and positive development.

Though the trend line is headed downward, we should be realistic about the levers of influence that the Kremlin retains: one of Europe's largest consumer markets, control over gas and electricity infrastructure in many neighboring countries, and a system of state-run companies that allows Russia to mix politics and business in a way that is impossible in the West.

Though the trend line is headed downward, we should be realistic about the levers of influence that the Kremlin retains: one of Europe's largest consumer markets, control over gas and electricity infrastructure in many neighboring countries, and a system of state-run companies that allows Russia to mix politics and business in a way that is impossible in the West. In order to protect the West and its allies from potentially malicious influence and — more importantly — to provide space for countries such as Ukraine, Moldova, Georgia, and other countries between Russia and the EU to make autonomous political choices, there are several steps the West can take to reduce the likelihood that economic ties can be used as effective tools of political coercion.

First, the European Union should double down on its energy strategy. It is currently in the midst of antitrust action against Gazprom, a case that should be prosecuted vigorously. European action against Gazprom's attempt to halt the reverse flow of natural gas has increased energy security in Europe, above all for Ukraine. The more Europe does to push for spot pricing in gas, the more competitive and transparent the continent's energy markets will be.

The most egregious potential threat to these positive moves in energy is the proposed Nord Stream II pipeline expansion, which would ship gas directly from Russia to Germany, bypassing the rest of Central and Eastern Europe. It is intended to replace the gas that currently transits Ukraine, as Russia is looking to halt the transit of gas through that country.[28] If the pipeline were built in the absence of further market reforms and infrastructure investments, it would significantly reduce energy security in Eastern Europe.

The pipeline would have an array of negative geopolitical effects, above all for Ukraine. Europe does not need additional pipeline capacity — the first Nord Stream is only partially utilized.[29] Instead, Russia's goal is to remove the leverage Ukraine gains from today's transit system. If Russia cuts of gas to Ukraine, all of Europe suffers. But with a new direct pipeline to Germany, Russia might be able to cut off Ukraine without causing a supply disruption to Europe. Ukraine would stand alone.

The pipeline is a sop to Germany's Social Democrats (SPD), who have a long history of cutting gas deals with Russia that risk increasing the Kremlin's political leverage. The first Nord Stream pipeline was approved by former Chancellor Gerhard Schröder, who took a job as chairman of the pipeline company immediately after leaving office and who remains influential in his party; the firm's managing director is a former Stasi agent and long-time Putin associate. Given such management, it is hard to see how the pipeline could be just a "commercial" project. True, if the pipeline's

[28] D. Pinchuk, "Gazprom Reiterates No Gas Exports to Ukraine after 2019," *Reuters,* June 9, 2015, http://uk.reuters.com/article/russia-gazprom-supplies-idUKL5N0YV2EK20150609. Some Russian officials have since suggested that this policy is unrealistic.

[29] D. Pinchuk, "Russia's Gazprom Cancels Plans to Expand Nord Stream," *Reuters,* January 28, 2015, http://www.reuters.com/article/russia-gazprom-nordstream-idUSL6N0V71A620150128.

construction was coupled with investment in new gas infrastructure and market reforms, the negative effect on Eastern European energy security could be reduced. But there is little sense in building an expensive and unnecessary pipeline and then spending additional funds to mitigate the political effect on Eastern Europe. The end result would be needless expenditure and even more excess pipeline capacity between Russian and Europe. There is still a good chance that the European Commission will rule that the project violates European law. It should be cancelled immediately.

On the trade front, the West has taken important steps to open its markets to goods from Ukraine, Moldova, and Georgia, which have suffered from Russian sanctions. A key impediment to closer economic integration between these countries and the West is the dire state of transportation infrastructure. The West should do more to modernize roads, railroads, ports, and airports in order to cut transaction costs and make it easier for companies in these countries to reach Western consumers. In Ukraine, in particular, infrastructure investment would also boost the country's ailing economy and could play a useful role in employing the many coal miners and factory workers who have lost their jobs because of the conflict in the East — and who constitute a potentially dangerous political group. Efforts are already underway in collaboration with Mikheil Saakashvili, the governor of Odessa and former president of Georgia, to build a new highway to Romania, which will expand weak trade links. This should be scaled up.

Some of the efforts to insulate Eastern Europe from Russian economic leverage will save money. Forging a functioning gas market in Europe, for example, will help hold down average prices, reducing what Europeans pay for energy. Other steps will be expensive. Lithuania has spent millions, for example building infrastructure that reduces its dependence on Russian gas and electricity. These steps may not have been commercially viable, but they served a key political goal. All of these efforts will impose a greater burden on Europe than on the United States. It is the European Union whose markets matter most to Ukraine, Moldova, and Georgia, and it is EU member states that will have to fund new energy infrastructure.

For Western leaders, the goal should be to strike a balance between the realities of economic interdependence and the need for political autonomy. Russia is a big country on Europe's borders, and cutting off trade is in no one's interest. But trade practices must be fair: the EU cannot let Russia take advantage of countries such as Moldova, Georgia, and Ukraine via abusive trade practices intended for political gain. In practice, that means demanding that markets are competitive and transparent. Applying those principles, and building the infrastructure needed to break monopolies that were inherited from the Soviet period, would reduce the risk that Russia uses trade and energy as a political tool. The EU's economy is more than ten times larger than Russia's. So long as Europe's market is unified, competitive, and transparent, the EU need not fear its smaller neighbor.

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