Assessing Russia's Economic Footprint in the Western Balkans: Understanding the Nexus Between Corrosive Capital and Governance Deficits

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Chairman Wicker and Co-Chairman Smith, Distinguished Members of the Committee, Senate and the House of Representatives, Your Excellencies, Dear Guests,

I wish to begin by thanking the Center for International Private Enterprise, and its Managing Director Andrew Wilson, for the partnership; the National Endowment for Democracy for its support, and the Helsinki Commission for taking the time and initiative to examine the issues that are key to the security and prosperity of the Balkan region:

- The Western Balkans have become one of the regions, in which Russia, among others, has increasingly sought to (re)assert its presence in the past decade. Thus far, the region has remained on its chosen course of Euroatlantic integration towards market economy and democratic transition. But the countries from the region need to not just recognise their vulnerability but also know their level of that vulnerability, and work to close existing governance gaps, which allow the penetration of corrosive capital and democratic backsliding.
- To improve the understanding of the interplay of existing governance gaps and corrosive capital from non-democratic countries, we, at the Center for the Study of Democracy (CSD), a Sofia-based European think tank, together with the Center for International Private Enterprise (CIPE), and experts from the Western Balkans developed an assessment of Russia's economic footprint in Serbia, Montenegro, Macedonia, and Bosnia and Herzegovina. The assessments build upon CSD's previous work – the Kremlin Playbook, which analysed Russia's influence in Central and Eastern Europe.
- The Russian economic footprint in the four assesed countries has noticeably expanded in absolute numbers over the past decade. Russia has grown from a peripheral economic power to a significant player in the region. In terms of share of the economy, the Russian presence has remained more or less stagnant amid the continuing moderate growth of the four economies. In some countries, Russia's economic footprint in the Western Balkans has shrunk in the wake of economic recession and international sanctions following its annexation of Crimea. Yet, in others, it has deepened and has even amplified rising political and soft power, including over media.
- The Russian corporate footprint or the share of Russian companies' revenues of the four economies' total turnover hovers between 6.5 and 10 percent. Russia's economic presence is highly concentrated in strategic sectors such as energy, banking, mining and real estate.
- Although it has been most significant and most diversified in Serbia, until Deripaska's 2013 withdrawal from the KAP aluminum plant in Montenegro, close to one-third of

that country's economy was under the direct and indirect control of Russian firms. Even today, Russian FDI stock in Montenegro is close to 30 percent of the country's GDP.

- The Russian footprint is least pronounced in Macedonia, where Russian FDI tops out at only 1 percent of GDP. In Bosnia and Herzegovina and Serbia, the footprint is about equal: Russia exerts direct and indirect control over about 10 percent of the economy of Serbia, primarily in energy and banking. In Bosnia and Herzegovina, Russian FDI is concentrated in Republika Srpska, where in 2014 – according to the latest available data – Russia-owned companies controlled 39 percent of the total corporate turnover in the hands of foreign companies.
- The indirect footprint of Russian companies generally goes through several channels, including 1) the dependence of local companies on imports of Russian raw materials such as natural gas; 2) debts accumulated for gas supply; and 3) the dependence of domestic companies on exports to Russia or loans provided by Russia-controlled banks, for example the subsidiaries of Agrokor.
- An overreliance on Russian energy imports, coupled with an expansion of Russian capital, has made the governments of the Western Balkans particularly susceptible to pressures on strategic decisions related to not only energy market diversification and liberalization, but also Russian sanctions and NATO and/or EU integration.
- Russian state-owned and private energy companies dominate the region's oil and gas sectors. These firms have gained influence through a series of non-transparent privatization deals for lucrative assets, such as the Serbian companies NIS and Beopetrol, the Brod refinery in Bosnia and Herzegovina, and Skopje heating company in Macedonia. These countries remain almost entirely dependent on supplies of Russian gas, allowing Gazprom to charge some of the highest prices for gas in Europe.
- Russian companies have also taken advantage of the closed nature of regional oil and gas markets to solidify their dominant position, successfully exploiting governance deficits, such as delays in market liberalization, a reliance on intermediaries for wholesale supplies of gas, and an unwillingness to advance diversification projects. Furthermore, Russia has locked regional governments into costly energy projects, such as the South Stream pipeline, overwhelming poorly resourced regional governments' administrations, and exposing the Western Balkan nations to fiscal risks.
- Non-transparent privatization, in which asset valuations did not stem from objective economic assessments, have enabled Russian businesses to expand their economic presence in a number of key industries to the detriment of the host countries. Too often, these companies have received preferential treatment, including tax regimes and energy subsidies, but rarely complied with the terms of their privatization agreements, leading to losses for taxpayers and state budgets alike.
- To exploit these governance gaps, Russia has captured local power brokers by offering government-sponsored business opportunities at premium returns. These intermediaries in turn have benefitted from further business opportunities or Russian support for their political objectives. Ultimately, the concentration of power in small influential economic-political networks creates vulnerabilities that Russia can exploit to affect public and private decision-making.
- Finally, to amplify the effect of its economic footprint, Russia has deployed an array of traditional soft power instruments, including through media, support for pro-Russian non-profits and political parties, as well as high-level political visits and statements. These tools have been used to leverage both current governments and opposition groups, depending on which means suit Russia's ends.

Recommendations

Based on the findings of our study, we have made a number of targetted policy recommendations:

- There is a strong need for diversifying foreign direct investment away from an overreliance on corrosive capital from non-democratic countries that is concentrated in one or two industries.
- The corporate governance of state-owned energy companies should be depoliticized and improved because otherwise they can be decapitalized through long-term deals granting preferential treatment to clients that enjoy special status from the government.
- All infrastructure projects should be in compliance with the highest standards for transparency and competitive tendering, and subject to independent cost-benefit analysis.
- Independent institutions for privatization and follow-up monitoring should be strenghten through the appointment, by parliament, of staff free from any influence.
- Similarly, countries should enhance the investigative capacities of their financial intelligence institutions, tax administration, and anti-money laundering institutions to identify the ultimate beneficial ownership of foreign investors in order to prevent tax evasion and money laundering.
- The EU, its member states and the U.S. should substantially enhance their assistance mechanisms, parituclarly to counter corruption, to help the most vulnerable countries in the region build greater resilience to corrosive capital inflows.
- The US and EU should work together on joint coalition-building mechanisms in the Western Balkans to support the capacity-building of civil society and independent media to monitor and expose corruption, state capture and external risks.
- The private sector in the region, through its support organizations, should engage in a constructive dialogue with the national government on shaping a corruption free business environment and open, competitive markets in line with international standards, such as the ones developed by the Organisation of Economic Cooperation and Development and/or the EU.