

## RUSSIA'S ECONOMIC INFLUENCE IN THE BALKANS: TACKLING KREMLIN'S SHARP POWER

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The European Union's decision<sup>1</sup> from October 2019 not to start accession negotiations with Albania and North Macedonia is yet another warning sign that the EU might not be willing and/or able to commit the necessary political capital to integrating the Balkans within the Euro-Atlantic community. The unexpected decision has **undermined the credibility of the EU enlargement process**, as well as that of the separate Berlin Process initiated by Germany in 2014 to reassure the Western Balkan countries of their European future. This has further weakened the EU gravitational pull, widening the **power vacuum** in the region that has been readily exploited by authoritarian powers such as Russia and China. The latter are taking advantage of the democratic backsliding and the widespread **corruption and state capture**<sup>2</sup> to expand their economic and political influence in the region.

Local political elites in the Balkans have readily embraced the proposed alternative authoritarian model touted by Russia and China, sweetened by

<sup>1</sup> The Council of the European Union failed to endorse the recommendation of the European Commission to start negotiations with Albania and North Macedonia. France, backed by the Netherlands and Denmark, have been the main opponents for starting the negotiations.

<sup>2</sup> Shentov, O., Stefanov, R., Todorov, B. (Eds.). 2016. *Shadow Power: Assessment of Corruption and Hidden Economy in Southeast Europe*. Sofia: Southeast European Leadership for Development and Integrity/Center for the Study of Democracy.

\* *The analysis focuses on Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Montenegro, North Macedonia, and Serbia, collectively referred as the Balkans and Southeast Europe. More details about the Russian influence in the region can be found in: The Kremlin Playbook in Southeast Europe: Economic Influence and Sharp Power. Sofia: Center for the Study of Democracy, 2019.*

### KEY POINTS

- The weakening of the EU gravitational pull leaves a power vacuum in the region that is readily filled in by authoritarian powers such as Russia and China. They are **taking advantage** of the democratic backsliding and the widespread **state capture** among dysfunctional institutions to expand their economic and political influence.
- Russian economic influence has declined since the imposition of U.S. and EU sanctions in 2014, but **Russian companies still control between 5 and 10% of the regional economy**, including strategic companies such as the largest refineries, fuel distribution networks, gas transmission and storage facilities, telecoms and retail chains.
- Russia has locked in governments from the region in **costly large-scale projects** that have been used to feed networks of domestic and Russian businesses with significant leverage over policy-makers and institutions.
- The Kremlin has amplified its influence and yielded sharp power in the region through employing all instruments from its playbook, such as supporting mainstream and fringe political parties, employing media, cultural and religious ties, sponsoring civil society activities, and pulling former security services' strings.
- SEE countries, with the help of the EU, should implement a diverse set of strategies to **counter state capture** in strategic economic sectors and **diversify foreign direct investment**.
- Anti-money laundering and anti-trust authorities should clearly establish final beneficial ownership, **prevent illicit capital** from entering the region, and **prioritise work on the risks posed by capital from authoritarian states serving political goals**, in particular large-scale infrastructure projects.

large scale unaccountable infrastructure and energy projects. This has undercut local democratic institutions and has further reduced the EU's conditionality-based accession negotiations' impact. For example, Serbia has pressed on with its strategic engagement with Russia<sup>3</sup> and China, although the EU started accession negotiations with the country in 2014. In what might be seen as a move to counterbalance the failure of the EU accession process to pull in Serbia and other Western Balkan countries and reverse their democratic backsliding, the U. S. has increased its engagement in the region. It has appointed two special envoys<sup>4</sup> in 2019, and has pressed on with NATO enlargement.<sup>5</sup>

The impact of **Russia's economic footprint on the Balkans** in particular has been underestimated by Western governments, resulting in a failure to recognize the true extent of the associated sharp power and structural risks. Russia remains the most influential external player in its ability to mobilize oligarchic networks domestically to acquire strategic assets or to try to tilt the foreign policy orientation of countries in the region.

The EU's decision to block the Western Balkans' accession process can at least partially be traced back to the success of strong Russian meddling in the decision-making of national governments in the region. In the past decade, **the Kremlin has relentlessly placed Balkan governments under pressure** through deploying the full array of instruments

from its **sharp power playbook**.<sup>6</sup> from economic dependence underpinned by corruption and state capture, through coordinated political and media disinformation campaigns, to special security services' operations. Russia aims to use this geopolitical opening to reignite regional divisions and derail the region's EU integration. The Kremlin is likely to view the Balkans as an important building block in its global strategy to outmaneuver the U.S. and the EU, and to position itself as important power broker. This strategy has been visible in the Middle East (Syria and Turkey), Central Asia, Africa and increasingly South America.

## State Capture Driven Economic Influence

Russia has been very apt in employing strategically its economic resources to exert pressure abroad, which has been a particularly visible strategy in Southeast Europe (SEE).<sup>7</sup> However, Russia's economic influence goes well beyond what the official statistics tell. In fact, looking only at the official statistical data, Russia's presence in SEE has declined across the region since the imposition of U.S. and EU sanctions following the annexation of Crimea in 2014. **Russian companies control directly or indirectly between 5 and 10% of the regional economy** down from around 15% on average in 2006.<sup>8</sup> Russian investments of between EUR 5.1 billion and EUR 7.5 billion (counting indirect Russia-owned foreign

<sup>3</sup> For example, in 2019 Serbia signed a free-trade agreement with Russia's Eurasian Union, deepened military ties with Russia, and pressed on with the Russian strategic political project in the region, the Turkish Stream pipeline. In an attempt to further hurt reformist governments, following the EU decision not to invite the two countries to start negotiations Russia has also suggested that Albania and North Macedonia should instead join its Eurasian Economic Union.

<sup>4</sup> The U. S. has appointed Ambassador Matthew Palmer as Special Envoy for the Western Balkans, and Ambassador Richard Grenell as Serbia-Kosovo peace envoy.

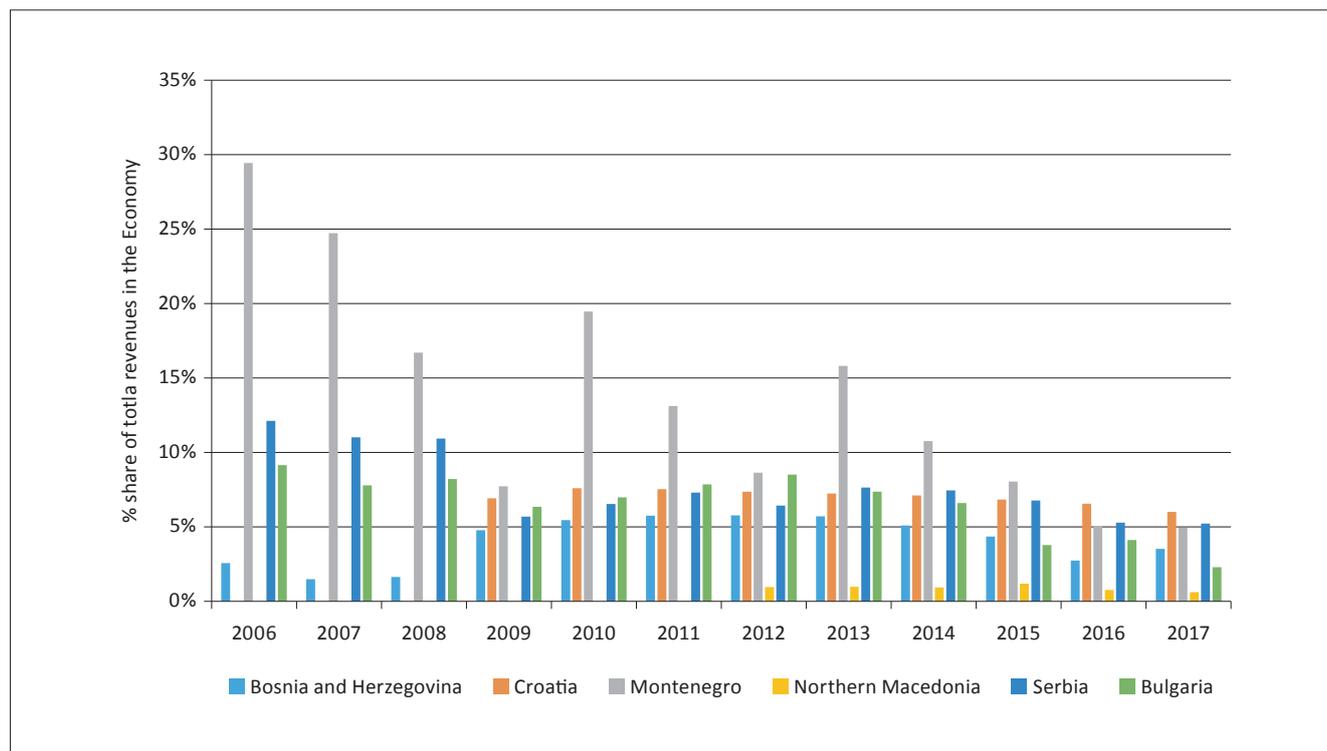
<sup>5</sup> Montenegro became NATO's 29<sup>th</sup> member in 2017, and North Macedonia is expected to become NATO's 30<sup>th</sup> member by April 2020.

<sup>6</sup> Conley, H., Stefanov, R., Mina, J., and Vladimirov, M. 2016. *The Kremlin Playbook: Understanding Russian Influence in Central and Eastern Europe*. Rowman & Littlefield.

<sup>7</sup> Vladimirov, M. et al. 2018. *Russian Economic Footprint in the Western Balkans: Corruption and State Capture Risks*. Sofia: Center for the Study of Democracy.

<sup>8</sup> The numbers indicate the share of Russia-controlled companies' turnover in the total turnover of all companies in the economy. For a more detailed methodological description see: Vladimirov, M. et al. 2018. *Russian Economic Footprint in the Western Balkans: Corruption and State Capture Risks*. Sofia: Center for the Study of Democracy.

**Figure 1. Operating Revenue (Turnover) of Russian Controlled Companies as a Share of Total Operating Revenue for the Economy in Selected Balkan States (%)**



**Note:** There is no reliable data available for Albania and North Macedonia.

**Source:** CSD calculations based on statistics from national and international corporate databases.

direct investment from offshore destinations)<sup>9</sup> have entered the region since 2006. This represents less than 5% of the total FDI stock.<sup>10</sup> Similarly, the significance of the region's bilateral trade deficit with Russia, largely driven by oil and gas imports, has declined since 2008 from 5.6% of GDP to 1.4% on the back of lower prices and more diversified trade.

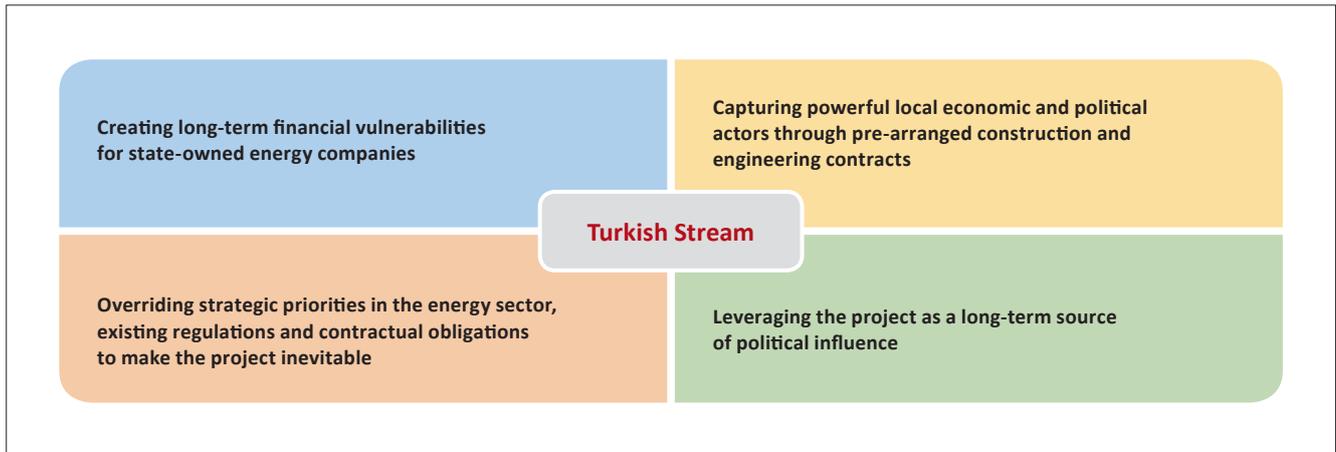
Still, Russia-controlled capital has been heavily invested in **targeted strategic sectors** including **energy, infrastructure, communications, finance and retail**. In these sectors, Kremlin-related firms have acquired some of the biggest enterprises in the region including Bulgaria's largest telecom, BTC (operating under the

brand name Vivacom), Serbia's oil and gas company NIS, and the Western Balkans' most significant retail chain, Agrokor. Russian oil and gas companies have continuously **hampered the diversification of energy supply** and the liberalization of energy markets in the region. They have successfully cemented their control over the largest refineries, fuel distribution networks and gas transmission and storage facilities across the region. They have also locked in the region in **costly and economically questionable large-scale projects** such as the Turkish Stream gas pipeline that have been used to feed networks of domestic and Russian businesses with significant leverage over policy-makers and institutions.

<sup>9</sup> The actual Russian investments in the region could be much higher, though, if all Russia controlled investment flows channeled through offshore areas such as Cyprus or the use of preferred intermediate investment countries like the Netherlands, Luxembourg, and Austria, could be considered in full. These countries are among the largest foreign investors in Serbia and Bulgaria, for example. Russian final beneficial ownership of such investments cannot always be accounted for.

<sup>10</sup> One notable exception is Montenegro, where Russian FDI stock has reached its peak at 13% of the total and close to one-third of the country's GDP. The Montenegrin economy is also heavily dependent on the export of tourism services to Russia, which made up 22% of GDP in 2013 before falling to 8% in 2016. On the opposite spectrum from the analyzed countries are Albania and Kosovo where Russian economic presence is marginal, although there have been some indirect channels of Russian capital influx through local and regional intermediaries.

**Figure 2. Model of Russia’s Use of Turkish Stream as a Capture Tool**



Source: Center for the Study of Democracy.

To exploit the existing governance loopholes in the region, Russia’s strategy has been to **capture powerful local brokers** through providing them with government sponsored business opportunities at premium returns.<sup>11</sup> Through the country’s security apparatus, the Kremlin under president Putin has gained an increasing grip over Russia’s public and private majors and even over less important business interests.<sup>12</sup> This has increased the risk of the Kremlin exploiting opportunistic or strategic business interests abroad for furthering its foreign policy goals. The lack of capacity and willingness among financial regulators and security services in Europe, and in particular in Central and Eastern Europe, to investigate Russian business interest for meddling in local markets and politics has increased the opportunities for these risks to materialize further.

A common way to implement Russia’s strategy in the region has been to **use former security officials** with significant influence over parties, businesses and institutions to act as intermediaries boosting Moscow’s interests where necessary. The reverse has also been

happening in the region when local powerful economic groups leverage their Russia links to secure capital and political backing to acquire assets and invest in large projects. Sometimes domestic interests have vied for and received the economic and political support from Russian companies to engage in rent seeking with their national governments, exploiting the lack of oversight and rule of law. In exchange for providing their brand name or capital (fronting), Russian companies have taken nominal share in lucrative domestic businesses, and gained access to strategic assets in telecommunications, finance, and most often in energy.<sup>13</sup>

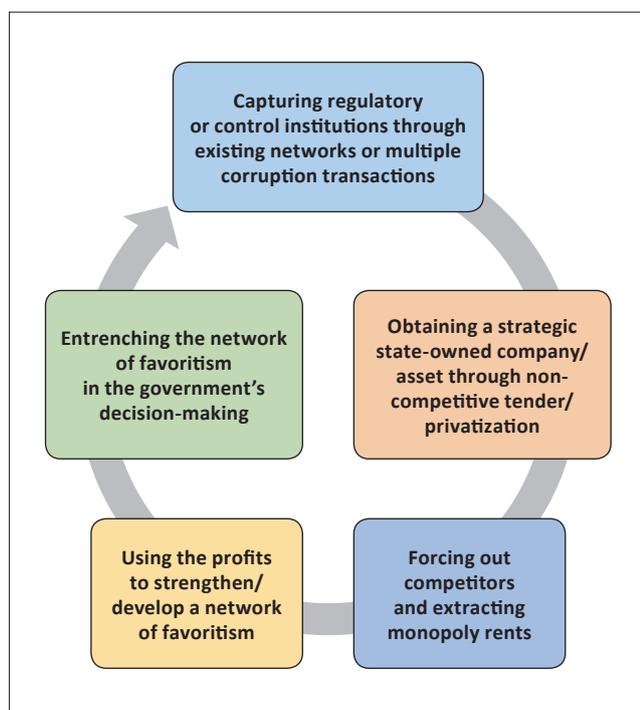
## Amplifying Russian Economic Influence Through Sharp Power Tools

There are different mechanisms that Russia uses in order to amplify its economic influence in SEE,<sup>14</sup> including:

<sup>11</sup> Shentov, O., Stefanov, R., and Vladimirov, M. (Eds.). 2018. *The Russian Economic Grip on Central and Eastern Europe*. Routledge.  
<sup>12</sup> Conley, H. A., Ruy, D., Stefanov, R., and Vladimirov, M. 2019. *The Kremlin Playbook 2: The Enablers*. Rowman & Littlefield.  
<sup>13</sup> Stoyanov, A., Gerganov, A., and Yalamov, T. 2019. *State Capture Assessment Diagnostics*. Sofia: Center for the study of Democracy; Shentov, O., Stefanov, R., and Vladimirov, M. (Eds.). 2018. *The Russian Economic Grip on Central and Eastern Europe*. Routledge.  
<sup>14</sup> Vladimirov, M. et al. 2018. *Russian Economic Footprint in the Western Balkans: Corruption and State Capture Risks*. Sofia: Center for the Study of Democracy.

- Leveraging **structural economic vulnerabilities** (most effectively in the energy sector) to achieve an outsized political influence in seemingly unrelated decision-making areas.
- Developing **state capture networks** by incorporating influential power brokers through corruption or intimidation and by pulling old-time security networks' strings.
- Exploiting the lack of independence of regulators and the widespread **deficits in the management of state-owned enterprises** in the energy sector to enable lucrative deals, prevent competition on energy markets and guarantee the country's support for Russia-led infrastructure projects.
- Supporting both **mainstream and fringe political parties** often having effective channels of influence over the whole political spectrum, which is especially true for Bulgaria, Serbia and Montenegro.
- Aligning official Russian government narratives with disinformation and propaganda channels through **media capture** and other forms of influence.

**Figure 3. How the Kremlin uses state capture to achieve political influence**



**Source:** Center for the Study of Democracy.

One of the most effective mechanisms for amplifying the state-capture-based Russian economic influence has been the activating of **sharp power instruments** such as media capture, cultural and religious ties and sponsoring of civil society activities.<sup>15</sup> On the surface, these tools can be seen as part of the soft influence toolbox as they harness a specific exchange of ideas about the role Russia plays in Europe. But underpinned by **targeted economic presence in the media sector** and **aggressive military and geopolitical posturing**, in practice they have successfully changed socio-cultural narratives in many SEE countries. Russia has actively sought to undermine societal perceptions about Western values, national policy objectives and cultural-historical realities by openly questioning facts, on the one hand, and by pushing forward narratives not grounded in evidence, on the other. The outcome of this strategy has been an increase of social tensions and political instability in SEE driven by Russia's exploitation of existing divisions in society. The most visible fault lines on which the Kremlin has put further pressure have been the growth of ethnic nationalism in Bosnia and Herzegovina, the anti-NATO protests in Montenegro and the political turmoil in North Macedonia following the 2016 elections. Russia-supported groups have played a key role in **fomenting internal conflicts** with the objective of changing strategic national decisions.

One of the key channels of Russian sharp power in SEE has been **the Orthodox Church**. It plays the role of a key spiritual intermediary for the spread of the Russian agenda in SEE, organizing various initiatives under a religious veil. Paradoxically, the Russian and many SEE orthodox churches have been bastions of former security services, further strengthening the Kremlin's influence. Another channel of sharp power is the saturation of the regional media space with Russian propaganda and disinformation narratives. Russia has exploited financial problems in content provision and the low level of media freedom in SEE to push forward Kremlin favorable free content, reinforce media economic dependency through direct capital ownership or advertising flows, and foster

<sup>15</sup> Cardenal, J. P. et al. 2017. *Sharp Power. Rising Authoritarian Influence*. National Endowment for Democracy, International Forum for Democratic Studies.

(in)formal political links of media outlets to pro-Russian groups and interests. The lack of transparency of media ownership, combined with weakly enforced conflicts of interest and ethical provisions, has been reinforced by the dependence on large commercial advertisers in small advertisement markets as well as by **the oligarchization of the media markets in SEE**.<sup>16</sup> Russia has also secured political influence not only by directly supporting mainstream and fringe political parties alike, but also by fomenting popular discontent and exposing the vulnerabilities of the liberal democratic system of governance through the following **set of enablers**:

- **Civil society organizations** and **quasi-political parties** receiving direct official or hidden financing from Russian foundations or local Russia-proxy funders, including banks.
- **Protest and pressure groups** mobilized on an ad-hoc principle to sow confusion and push back against specific government decisions. These have often been linked to football clubs, combat sport clubs, etc., which have received support from Russian businesses.
- **Internet trolls, bloggers, talk-show hosts** and creators of obscure news websites aiming to amplify certain disinformation narratives.

## Policy Recommendations

Based on the uncovered size and patterns of Russian influence in SEE, the following non-exhaustive list of policies<sup>17</sup> could be considered for reducing its negative impact:

- **National governments** in Southeast Europe should implement **robust strategies to counter state capture** including the implementation of annual *State Capture Assessment Diagnostics* (SCAD) that would measure the level of capture (risks) of strategic economic sectors and identify key governance

deficits allowing excessive market concentration in favor of private interests.

- SEE countries should focus on the **diversification of foreign capital inflows** away from the overreliance on capital from authoritarian countries targeting structurally important sectors through non-competitive means. Foreign direct investment exposure should be assessed adequately by central banks and financial regulators, which should regularly underestimate the true size and potential impact of capital inflows from Russia.
- SEE governments need to **revamp and strengthen their capacity** to counter effectively the instruments of Russian influence in critical sectors of the economy, and in particular in energy. These efforts should be part of their national security strategies and included publicly in annual reporting/threat assessment on Russia, including its economic and energy presence.
- SEE governments should **prioritize the improvement of their countries' energy security** through the following policy measures:
  - full natural gas market liberalization in line with the EU energy and competition laws;
  - completion of the regional market integration through the construction of pipeline interconnectors, gas storage facilities and underground storages, as well as the diversification of supply routes and sources;
  - renegotiation of long-term natural gas contracts with Gazprom in order to abolish destination and take-or-pay clauses, as well as to remove the oil indexation from the pricing methodology.
- The involvement in the Russia-led large-scale **politically driven energy projects** such as the Turkish Stream gas pipeline and the Belene nuclear power plant should be reconsidered in light of the impact the projects have in lowering energy security and in reinforcing Russia-backed state capture networks.
- National tax and anti-trust authorities should increase their efforts to prevent Russian companies

<sup>16</sup> Filipova, R. et. al. 2018. *Russian Influence in the Media Sectors of the Black Sea Countries: Tools, Narratives and Policy Options for Building Resilience*. Sofia: Center for the Study of Democracy.

<sup>17</sup> These build upon the recommendations provided to the Bulgarian Presidency of the Council of the EU in May 2018. For more details, see: Center for the Study of Democracy. 2018. *Policy Brief 77: Making Democracy Deliver in the Western Balkans: Strengthening Governance and Anticorruption*.

from engaging in tax **avoidance and abuse of monopoly power** by:

- implementing the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations in their bilateral government-to-company tax negotiations, so as to limit the amount of profits shifted to offshore-registered subsidiaries;
- breaking the existing oligopolistic structure of the fuel distribution markets in the region allowing the Russian oil majors to extract monopolistic rents that could be redirected to finance non-energy activities including indirectly political parties media propaganda, cultural activities and educational programs.
- Anti-trust authorities, tax inspectorates, financial market regulators and national security agencies should work **to clearly establish final beneficial ownership** and links with other players on the market, so as to avoid market concentration, and prevent money laundering and the acquisition of critical assets by companies linked to authoritarian states.
- There is a need to **strengthen the governance of privatization and post-privatization procedures**, so as to dissuade Russian attempts to take over large-scale strategic companies at below-market value.
- Political party financing should be more strictly regulated and relevant intelligence bodies should strengthen their **monitoring of foreign subversive activities**.
- The **independence of national media regulators** should be strengthened, so that they can shed light on media ownership to avoid undue market concentration and to uncover under-the-radar online media outlets that serve to spread disinformation and propaganda.
- The **European Union** should reinforce its **economic and political engagement on the Balkans** through the enlargement process for non-EU countries and through its cohesion policy in EU members. It should seek in particular a more active political engagement in the areas of rule of law and anticorruption. It should also stress more assertively to local political leaders that the long-term EU prospects require further reforms on the ground and refusal to engage with non-EU players on exclusive deals outside the framework of open competition and rule of law.
- The EU, and in particular, France and Germany, should agree on a **revamped enlargement policy** balancing the political and technical elements of the process. The EU should reassure the Western Balkan countries of their European future, but it should also make clear that the enlargement process is first and foremost a political process aimed at strengthening the democracy and market economy in the region. The EU should re-emphasize the preeminence of achieving a certain threshold of economic development in order to join the union.
- The EU should also provide an example by **introducing a solid rule of law mechanism for the member states** based on continuous structural and anti-corruption reforms and linked to cohesion support.
- The EU should **include the Western Balkans in its Multiannual Financial Framework** planning, providing a stronger basis for the integration of the region and encouraging private EU investments. In particular, the EU should aim to **engage directly with civil society** in SEE, including through Brussels-managed programs on rule of law, justice, etc.
- The EU should step in much more assertively to **develop regional energy cooperation** and integration into the EU, including through strategic energy projects and the introduction and verification of EU energy rules and regulations.
- The EU should **improve cooperation with national anti-money laundering institutions** to trace illicit financial flows. The European Commission and the European Central Bank should enhance efforts to enforce AML legislation and close loopholes in the corporate ownership and foreign direct investment regulatory frameworks. There is a need to successfully implement the EU decision to form a Beneficial Ownership Registry and make it freely available to the general public.
- The **United States** should use more aggressively the Foreign Corrupt Practices Act as well as expand the scope of the Global Magnitsky Act to investigate high-level corruption practices in Europe that enable Russian strategic interests.

## **Publications by the Center for the Study of Democracy**

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