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Foreign Meddling in the Western Balkans: Guarding Against Economic Vulnerabilities

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The Helsinki process, formally titled the Conference on Security and Cooperation in Europe, traces its origin to the signing of the Helsinki Final Act in Finland on August 1, 1975, by the leaders of 33 European countries, the United States and Canada. As of January 1, 1995, the Helsinki process was renamed the Organization for Security and Cooperation in Europe (OSCE). The membership of the OSCE has expanded to 56 participating States, reflecting the breakup of the Soviet Union, Czechoslovakia, and Yugoslavia.

The OSCE Secretariat is in Vienna, Austria, where weekly meetings of the participating States' permanent representatives are held. In addition, specialized seminars and meetings are convened in various locations. Periodic consultations are held among Senior Officials, Ministers and Heads of State or Government.

Although the OSCE continues to engage in standard setting in the fields of military security, economic and environmental cooperation, and human rights and humanitarian concerns, the Organization is primarily focused on initiatives designed to prevent, manage and resolve conflict within and among the participating States. The Organization deploys numerous missions and field activities located in Southeastern and Eastern Europe, the Caucasus, and Central Asia. The website of the OSCE is: <www.osce.org>.

ABOUT THE COMMISSION ON SECURITY AND COOPERATION IN EUROPE

The Commission on Security and Cooperation in Europe, also known as the Helsinki Commission, is a U.S. Government agency created in 1976 to monitor and encourage compliance by the participating States with their OSCE commitments, with a particular emphasis on human rights.

The Commission consists of nine members from the United States Senate, nine members from the House of Representatives, and one member each from the Departments of State, Defense and Commerce. The positions of Chair and Co-Chair rotate between the Senate and House every two years, when a new Congress convenes. A professional staff assists the Commissioners in their work.

In fulfilling its mandate, the Commission gathers and disseminates relevant information to the U.S. Congress and the public by convening hearings, issuing reports that reflect the views of Members of the Commission and/or its staff, and providing details about the activities of the Helsinki process and developments in OSCE participating States.

The Commission also contributes to the formulation and execution of U.S. policy regarding the OSCE, including through Member and staff participation on U.S. Delegations to OSCE meetings. Members of the Commission have regular contact with parliamentarians, government officials, representatives of non-governmental organizations, and private individuals from participating States. The website of the Commission is: <www.csce.gov>.

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PARTICIPANTS

APPENDIX

Foreign Meddling in the Western Balkans: Guarding Against Economic Vulnerabilities

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January 30, 2018

Commission on Security and Cooperation in Europe
Washington, DC

The briefing was held at 9:59 a.m. in Room 385, Dirksen Senate Office Building, Washington, DC, Robert Hand, Senior Policy Advisor, Commission for Security and Cooperation in Europe, presiding.

Panelists present: Robert Hand, Senior Policy Advisor, Commission for Security and Cooperation in Europe; Andrew Wilson, Managing Director, Center for International Private Enterprise; Ruslan Stefanov, Director, Bulgarian Center for Study of Democracy; Milica Kovačević, President, Montenegrin Center for Democratic Transition; Nemanja Štiplija, Founder, "European Western Balkans" media outlet; and Dr. Dimitar Bechev, Research Fellow, Center for Slavic, Eurasian, and East European Studies, University of North Carolina-Chapel Hill.

Mr. HAND. It's getting quiet, so I think we can start. Usually, I have to step in and get everyone to tone down, but now everybody's anxious to go. Maybe that's a sign in the interest in the subject matter today.

So let us start. And as moderator, let me welcome the panelists, as well as the audience, to today's briefing. My name is Robert Hand. I'm a policy advisor at the U.S. Helsinki Commission. Our chairman is Senator Roger Wicker of Mississippi, and our co-chairman is Representative Christopher Smith of New Jersey.

This is the third commission briefing on the Western Balkans in three months. That fact underlines the ongoing concern of the Helsinki Commission for this region in Europe, despite many other issues which require so much attention.

Today's turnout for this briefing I think demonstrates that the commission is not alone in its concern for the Western Balkans. Let me, nevertheless, start by stressing why we are having this briefing, and why the stability of the Western Balkans and the democratic development and economic prosperity of the countries of the region remain so important to us, two decades or so after devastating conflict.

First, we have already devoted significant effort—political, economic, even military—not just to stopping those conflicts, supporting recovery, and preventing new conflicts. It only makes sense that we should complete this job. It's a commonsense argument and probably means greater commitment than we see now from United States as well as the European Union, but nothing near what was required in the past.

Second, these countries are next in line to each other as future aspirants to join the European Union. And most are similarly in line to join the NATO alliance. Indeed, some have already done so in the region. They each can make a small contribution, but collectively far from an insignificant contribution to both collective security and common prosperity in Europe. Being next in line, but still outside the safety of the club—especially at this time of uncertainty, conflict, and confrontation in Europe—may be the toughest place to be, accentuating the internal and external threats these countries face. As the foreign minister of Macedonia, Nikola Dimitrov, recently said on the matter: "Those on the inside tend to forget how cold it is outside."

Expectation can encourage reform, but reform generates expectation as well. If not met, internal reversals are sure to come. By external threats, or outside sources of instability, I mean those that seek to divert the Western Balkans from what otherwise seems to be a natural and genuinely popular European path, and also to seek opportunities for mischief that is far from innocent. Russia comes immediately to mind in this regard, and the attempted coup in Montenegro in 2016 as the country was finalizing its NATO bid is only the most blatant of many manifestations of these outside sources of instability. Moscow's attempts to steer public opinion in Serbia away from Europe and to encourage recalcitrance in the Republika Srpska entity of Bosnia-Herzegovina have also received our attention. The Kremlin also took interest in Macedonia during the course of the political crisis there.

This, of course, makes the Western Balkans more important, as the countries there are a stage on which a much bigger issue is playing itself out—namely, Moscow's aggressive behavior throughout Europe. As one expert witness told the Helsinki Commission last year at a hearing on Russia's threat to European security, the Western Balkans are in Russian crosshairs. We continue to read about Moscow exerting a malign influence in Europe and elsewhere. And considerable attention has been given to that issue here in the U.S. Congress. Turkey, various countries in the Middle East, and now China have also developed a presence in the Balkans, with some reason for concern regarding the implications for stability.

Our briefing today focuses on foreign meddling and, more specifically, how the absence of good governance and strong adherence to the rule of law give outside actors an opportunity to develop an economic footprint that can be used for political purposes. The four countries of primary focus this morning are Bosnia and Herzegovina, Macedonia, Montenegro, and Serbia. Of course, there may be some commonalities throughout the region, including countries not the focus of this morning's briefing. And we may comment on those as well.

And although the focus is primarily on Russia's economic footprint in these countries, the reform shortcomings that create vulnerabilities are of concern to the extent that they also slow the process of European integration and, let's remember, rob the citizens of the countries of economic opportunity and of increasing prosperity.

This is, of course, yet another reason why the Balkans are so important, beyond the concern about foreign meddling. The people of the region have already been traumatized so much by conflict that they deserve better from their own political leaders. Indeed, their political leaders have committed themselves in the OSCE to develop good governance, to adhere to the rule of law, to operate with greater transparency, and to combat corruption.

At the 2012 meeting of foreign ministers in Dublin, Ireland, for example, the OSCE adopted a declaration on strengthening good governance and combating corruption, money laundering, and financing of terrorism, which best expresses the commitment of all OSCE States in this regard.

We have an excellent panel today to discuss this important topic. You have their biographies. They were handed out to you as you signed in this morning, so I won't detail them here. Let's just start by thanking them, again, for coming. And let me particularly thank the Center for International Private Enterprise (CIPE) for taking its leadership role in working with partners in the region on this issue.

And so let me start with Andrew Wilson, the managing director of CIPE, to introduce the issue. Let me say how much I value CIPE's work. We deal a lot with other organizations dealing in the political affairs. But just as we know that we need free and fair elections in these countries, we also need to have free and fair markets, and that's where CIPE plays such an important role.

And then after we hear from Andrew, we will listen to some of the partners in CIPE who are visiting Washington, coming in from their home countries. And then we'll finalize with Dr. Dimitar Bechev, who will put it all together and give some comments and analysis on the region.

So with that, let me turn it over to Andrew and we'll start the presentation. When everybody's done, we'll then go to a question and answer period.

Andrew.

Mr. WILSON. Thank you, Bob, and thank you for the kind introduction. I'd like to thank Bob and the Helsinki Commission for his leadership on this important initiative, and welcoming the participants and attendees of this timely briefing.

Over the past decade, there has been an increase in the flow of funds from a number of non-democratic countries into emerging democracies. While in many cases, this might represent wholly legitimate investment, in other cases there are signs that governments have specifically sought to direct this capital to achieve purposes other than purely economic. At CIPE, we define this issue as corrosive capital, equity, debt, and aid that takes both advantage of and exacerbates weak governance in emerging democracies to the detriment of their democratic and market development, as well as to influence their geopolitical orientation. Corrosive capital can distort policymakers' incentives and decision-making, privileging the political influence of foreign governments over local citizens' voices.

CIPE welcomes the partnership with the Helsinki Commission and the opportunity to present today these knowledgeable panelists who will be speaking on how to respond to this challenge in the Balkans in particular. As we know, in the Balkans, despite the passage of nearly two decades since the end of armed conflict, democratic transitions remain woefully incomplete. Against that backdrop, in recent years external actors have reasserted their role, diverting the Balkans from a trajectory of Euro-Atlantic integration. As the panelists will explain, corrosive capital has emerged as a key element of that approach, posing a major challenge for governments, business communities, and civil societies across the region.

In response, in 2017, CIPE embarked on a unique project in pioneering a new comprehensive methodology to analyze, first, how what we call governance gaps, such as loopholes in anticorruption policies, nontransparent procurement policies, and a lack of strong competition policies create in the Balkans opportunities for the inflow of corrosive capital. And, second, how that capital widens those governance gaps and potentially undermines the consolidation of democracy in the region. A network of CIPE partners represented by the panelists today from across the region—Bulgaria, Montenegro, Serbia, Macedonia, and Bosnia and Herzegovina—have identified specific governance gaps and, in particular, have examined the extent and impact of Russia's economic footprint in the region.

Now, we recognize that in recent years the countries of the Balkans have made important progress. But as the panelists will discuss, judicial and executive institutions are still not sufficiently independent, efficient, or accountable. Implementation and enforcement of legislation is often weak and inconsistent. And further efforts are needed to tackle corruption and to make public budgeting, procurement, and privatization more transparent. We're honored that the Helsinki Commission has invited CIPE's partners here to inform a U.S. audience about these issues, just as they are raising awareness in their own countries. In addition, working with local business and civil society leaders, they are seeking to create greater transparency about foreign investment in the Balkans, and to advocate with policymakers to close those identified governance gaps.

By so doing, they aim to ensure that local businesses can compete on an equal footing and that all investors enjoy a level playing field. This, in turn, will make markets and democracies in the Balkans more resilient to potential untoward external influence and help ensure inclusive economic growth. This effort can contribute to democratizing economic opportunity in the Balkans, and countering the worrying spread of a perception in the region that democracy and markets have failed average citizens.

We note that the European Commission plans to adopt a new strategy to boost democratic transition and economic reforms in the region. By tackling the challenge of corrosive capital in the Balkans, CIPE is also developing tools and approaches that can benefit other emerging democracies worldwide, including across Asia, Latin America, and Africa. We look forward to future opportunities to share the results of that work with you as well.

Finally, I'd like to close by thanking the National Endowment for Democracy for its support of the CIPE program that engages today's panelists. Of course, such projects are, in turn, made possible thanks to the critical commitment of the U.S. Congress to funding the NED.

Thank you.

Mr. HAND. Thank you, Andrew. Our next speaker is Ruslan Stefanov. He is the director of the economic program at the Sofia-based Center for the Study of Democracy (CSD).

Ruslan.

Mr. STEFANOV. Thank you. Let me start by thanking the Center for International Private Enterprise and specifically its executive director Andrew Wilson for the partnership of the past more than 25 years, the National Endowment for Democracy for its support, and, of course, the Helsinki Commission for taking the time and leadership to examine the issues that are key to the security and prosperity of the Balkans region.

The Western Balkans have become one of the regions in which Russia, among others, has increasingly sought to assert its presence in the past decade. Thus far, the region has remained on its chosen course on Euro-Atlantic integration toward market economy and transition. But the countries from the region need to not just recognize their vulnerability, but know their level of the 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 Study of Democracy, together with CIPE and experts from the Western Balkans that you will hear from, have embarked on an assessment of Russia's economic footprint in Serbia, Montenegro, Macedonia, and Bosnia and Herzegovina. The assessment builds on previous work of CSD that you might have seen, the Kremlin Playbook, which analyzed Russia's influence in Central and Eastern Europe.

The Russian economic footprint in the four assessed countries has notably expanded in absolute numbers over the past decade. Russia has grown from a peripheral economic power to a significant player in the region. In some countries, though, Russia's economic footprint in the Western Balkans has shrunk in the wake of economic recession, international sanctions following its annexation of Crimea. Yet, in others, we've seen that it has deepened and has even amplified rising political and soft power, including over media.

The Russian corporate footprint, or the share of Russian company revenues of the four economies' total turnover hovers between 6½ 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, notably, until the withdrawal of Deripaska in 2013 from the KAP aluminum plant in Montenegro, close to one-third of that country's—Montenegro's—economy was under the direct or indirect control of Russian firms. Even today, Russian FoFDI stock in Montenegro is close to 30 percent of the country's GDP.

The Russian footprint is least pronounced in Macedonia, while 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 in Serbia, primarily in energy and banking. In Bosnia and Herzegovina, Russian foreign direct investment (FDI) is concentrated in the Republika Srpska, where in 2014—which is 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 general goes through several channels including, number one, the dependence of local companies on imports of Russian raw materials, such as, most notably, natural gas. Debts—number two—debts accumulated for gas supply. Number three, the dependence of domestic companies on exports to Russia, or loans provided by Russian-controlled banks. For example, the subsidiary of Agrokor, which drama we have seen play out in the past year. An over-reliance 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, notably, NATO and 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 nontransparent 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 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 huge fiscal risks.

Nontransparent 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 subsides, 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 benefited from further business opportunities or Russian support for their political objectives. Ultimately, the concentration of power in small, influential, economic and 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 nonprofits and political parties, as well as high-level political visit and statements. These tools have been used to leverage both current governments and opposition groups depending on which means suits Russians best.

Now, based on the findings of our study we have made a number of targeted policy recommendations that you could find in the papers outside or also the website of CIPE and CSD.bg. But let me just sort out some of the most important one. First, there is a strong need for diversifying foreign direct investment away from an over-reliance on corrosive capital from non-democratic countries. The corporate governance of state-owned energy companies should be depoliticized and improved because otherwise they can be decapitalized in long term deals granting preferential treatment to clients that enjoy special status from the government. All infrastructure projects should be in compliance with the high standards for transparency and competitive tendering. Independent institutions for privatization and follow-up monitoring should be strengthened by the appointment by parliament of staff free from any influence.

Similarly, countries should enhance the investigative capacities of their financial intelligence to 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 and its member states, as well as the U.S., should substantially enhance their assistance mechanisms, particularly to counter corruption to help the most vulnerable countries in the region build greater resilience to corrosive capital inflows.

[Background buzzer.] Is that for me to end? [Laughter.]

The U.S. 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.

And finally, something we've been doing with our partner from CIPE for the past 25 years, private sector in the region, through it 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 the best international standards, such as the laws developed by the Organization of Economic Cooperation and Development and/or the European Union. And with that, I'd like to thank you.

Mr. HAND. Thank you. And, no, that buzzer was not a response to your comments. Since we're here in the Congress, we do have these bells or buzzers that go off when one or the other chambers goes into session, when there's votes, et cetera. And so if it happens again, just ignore it. I should have mentioned it earlier to our visitors. But it's just the way that we keep our Members of Congress aware of what is happening on the floor and when they need to go for votes, et cetera.

Our next speaker is Milica Kovačević. Milica is president of the Center for Democratic Transition in Montenegro. Welcome. We look forward to your statement.

Ms. KOVAČEVIĆ. Thank you. And thank you very much for having us here to share our thoughts on the challenges facing the Western Balkans and our countries.

I'd like to start with a historical reference that I find really illustrative. During the Cold War, back in 1956, Yugoslav ambassador to Moscow, Montenegrin Veljko Micunovic, wrote to Yugoslav President Tito that history of our economic relations with Russia is not less dramatic than the history of our political relations. For Russia today, as in the past, every trade is a direct means of politics, he wrote. Even today, this sentence continues to remain valid, and the playbook for our region was always the same.

In the last decade, we saw a significant level of economic engagement by Russian companies and individuals in Montenegro. And in addition to economic relationships, Montenegro and Russia used to have sparkling political ties. Political relations, however, deteriorated since 2013, as Montenegro moved forward with its NATO integration. And so far, by the data that we have, this change in the relationship has not yet affected the economic ties between two countries. But there have been some warnings coming from senior Russian officials.

For example, in March 2017, Russian Foreign Minister Sergey Lavrov said that Montenegro has sacrificed its economic relation with Russia by joining NATO. The dependence of Montenegrin economy on Russian investment in real estate and in tourism still raises the possibility that further deterioration in bilateral relations could pose a risk to our economy. Ruslan already mentioned, today Russian foreign direct investment in Montenegro makes up close to a third of the country's GDP. Russia is the single largest indirect investor in Montenegro, with almost $1.3 billion U.S. of cumulative investment, which is equal to 13 percent of all foreign direct investments to the country. A majority of this FDI is concentrated in the real estate and the tourism.

The number of Russian tourists in Montenegro has consistently increased in the last 10 years. Russian tourists, according to the official data, make around one-quarter of the total number of country's visitors. And this is really important, because tourism is the key sector of Montenegrin economy, and the most powerful generator of economic growth. Today, it makes around one-fifth of Montenegrin GDP and over 54 percent of all exports.

However, on the other side, Russia's share of the overall Montenegrin economy significantly shrank in recent years from almost 30 percent of total revenue back in 2006 to around 5.5 percent in 2015. And this is largely a result of the withdrawal of the Russian capital from Podgorica's aluminum plant, KAP, one of the largest companies in the country. Similar trends are observed in the analysis of the number of the employees working for the Russian-controlled entities, which fell from over 14 percent in 2007 to just 2.3 percent in 2015. And, again, primarily because of the loss of the control of KAP.

Based also on the experience of some other countries in the region, where some of the initial Russian investment in the energy sectors spilled over to a number of other economic sectors, we can now only contemplate what would have happened if the parliament of Montenegro hadn't stopped the acquisition of country's energy resources by KAP's owner, Oleg Deripaska, in 2007. The government of Montenegro also rejected Russian request to use Montenegrin port of Bar for military purposes, despite the fact that Russia allegedly had a multibillion proposal, worth at least half of country's GDP. In 2014, Montenegro also aligned with the EU sanctions following the Russian annexation of Crimea.

Well, obviously prior to the admission to NATO, Russian Government condemned Montenegro's membership aspirations, but also actively worked to prevent it, in particular by backing up the nationalist groups whose policy platforms are at the odds with Western values. Russian Deputy Foreign Minister Dmitry Rogozin went even further when he said that Montenegro will regret joining NATO. In parallel, the Russian media started to run a negative campaign aimed at preventing Russian tourists from coming to Montenegro, describing it as a dangerous place.

Montenegro has accused the Russian Federation of meddling in the 2016 parliamentary elections by attempting to overthrow the government to the strongest opposition coalition in Montenegro, the Democratic Front. There is an ongoing court case for the coup attempt against some of the DF leaders for acting against the country's constitutional order. The indictment also includes two Russian military intelligence officers and several Serbian nationals, mostly members of the right-wing organizations and groups. Furthermore, another Democratic Front leader is being charged with participation in a money laundering scheme during the 2016 election campaign. Allegedly the DF used funds of criminal origin, provided in large amounts by Russia to offshore accounts and then split into small installations and sent to individuals who later donated the money to the party.

Nevertheless, Montenegro managed to resist the allegedly Russian-orchestrated use of both hard and soft power, joining NATO in 2017. But even NATO admission has not completely brought Montenegro out of the danger zone. Russian interests in the Western Balkans has never been to annex the region, but to keep it unstable and as far from the Western integration as possible. And many analysts in the region, and followers of the region would agree that the region's integration in the EU will be the next target of these campaigns. EU integration is supported by the overwhelming majority of the citizens of Montenegro, and by all key political actors.

The report that we prepared also examines the governance gaps that have been exploited for the intrusion of the corrosive capital, and offers recommendations how to close these gaps to prevent further deterioration. Addressing these gaps is essential for our democratic reforms, inclusive economic growth, and EU integration. In order to succeed, we remain determined to advancing the progress we made so far. And we would welcome even more international support.

At the end, I would like to thank you, the commission, and everyone here for the ongoing support and commitment to the region. The West should be persistent in demanding real democratic progress in our countries, because it's the key for a country's stability, security, prosperity, and resilience to harmful foreign influence, both in the region and beyond its borders. Civil society in the Western Balkans looks with hope at the United States enhanced diplomatic engagement, and relies on your help in ensuring that the region remains on its Euro-Atlantic integration path. Thank you.

Mr. HAND. Thank you very much.

Our next speaker is Nemanja Todorovic Štiplija, who's the editor in chief of "European Western Balkans," a web portal focusing on the European integration of the Western Balkans.

Nemanja.

Mr. ŠTIPLIJA. Thank you, Mr. Hand. Dear guests, thank you for the opportunity to appear before the commission today. Allow me to thank also the Center for International Private Enterprise, and the National Endowment for Democracy for their support and the opportunity to present our views here in Washington. We very much appreciate the interest of the Helsinki Commission in issues that are of the great importance of the stability and the future of the Western Balkans.

Serbia is one of the key countries where Russian influence is the most obvious. Since 2008, it has been based on two pillars. First, the issue of Kosovo. And the second, the Russian engagement in Serbian energy sector, which dates back to the South Stream construction deal, and the below-price purchase of the Serbian oil industry, shortly NIS. Furthermore, following particularly the global economic downturn in 2014 and 2014 Ukrainian crisis, the Russian influence has slipped over to the key economic sectors, such as the financial sector and the infrastructure. The economic engagement, high-level political visits, and strengthening cultural and religious ties mutually reinforce each other.

While most research has focused on the outright political influence, it has often disregarded the sophisticated networks in nation economics that exploit the democratic deficits in Serbia, and throughout Western Balkans. Despite the fact that South Stream was discredited, Russia still dominates Serbia's oil and gas sector. Through NIS, Russia almost completely runs oil production, refining, and retail. Serbia imports more than 70 percent of crude oil consumption, and close to 65 percent of its natural gas needs from Russia. What's more, Russia is the only importer of gas in Serbia, and it favors inflexible, long-term deals.

Through those deals, it has gained the eminent influence over a state-owned wholesale gas supplier, Srbijagas, which has, as a result, accumulated debt affecting Serbia's financial health. Srbijagas, the state-owned company, holds a dominant position on the national gas market. An intermediary, YugoRosGaz, which is owned by Gazprom, receives around 4 percent premium on the gas resales to Srbijagas. Besides Srbijagas, Russians generally do a lot of business with state-owned companies, and those with close connections to politics.

That is why the country needs to advocate the reform on its public administration as soon as possible. Gas diversification is long overdue. Furthermore, steps are needed to tackle the restructuring and privatization of Serbia's enterprises. Based on our analysis, lowering the budget deficit and reducing the high public debt level, including debt generated by companies of strategic importance, also remain a challenge.

With regard to the private sector, Russians fully or partly opened approximately 1,000 companies in Serbia. They control revenues of close to 5 billion euros, or 13 percent of the total revenue generated by the country's economy. Russian companies are also almost the major employers in the country, directly employing approximately 2 percent of total labor force, and indirectly employing 5 percent. What is important is that such employment is concentrated in just a few industrial enterprises.

Export to Russia has become an important aspect of the economic relationship between Russia and Serbia, particularly following the expansion of free trade agreement in 2009 and 2011. Russia's 2014 embargo on imports of EU agriculture or food products has provided a boost to export in non-EU countries in the Western Balkans. Nowadays, Serbia's export to Russia is highest by volume in the Southeast European region after Greece.

Russian foreign direct investment remained relatively small, amounting to 4 percent of all FDI stocks in Serbia, according to data available from 2005 to 2016. Should we account also investing—following from third states, but still attributed to Russians, along with their reinvestment from profit, the total Russian FDI would be around $2 billion, or 6 percent of country GDP.

During Serbia's fiscal crisis, Russia further deepened its engagement with the Serbian economy by adding loans to the array of other tools deployed to promote its interests. Some of these loans reportedly stipulate less favorable conditions than those of the international financial institutions, and even granted preferential status to Russian state-owned contractors for the infrastructure modernization projects.

While Russia's presence in the finance sector is somewhat limited, borrowing loans from Russian banks may involve risks, as shown in recent Agrokor crisis. Relying heavily on bank loans, this retail has recently expanded into almost all countries of the Western Balkans, including Serbia. In early 2017, not only Agrokor employed more than 60,000 people through the region, but also accumulated debt totaling around $6.4 billion, or 6 times its equity. Sberbank, the Russian state bank, owns around 18 percent of it. Despite the debt, Agrokor remained relatively stable until the statement of Russian ambassador to Croatia sent shockwaves through the market.

Again, in Russia's mind, the economic engagement and other tools manually reinforce each other. Russia attempts to widen influence also through initiatives in the spheres of media, culture, church, nonprofit and academia. It provides support, including financial, to organizations, groups, and individuals that promote Russian interest in foreign countries. In Serbia, Russia has supported development of several media enterprises and information initiatives of major Russian media outlets. For example, the state-owned news agency Sputnik opened its regional editorial office in Belgrade in 2015. They seek to disorient the local audience by offering narratives that exploit Serbia's weak spot and promote the Russian interests.

To conclude, I would like to stress that all relevant actors—whether Serbian, regional or international—need to recognize the potential costs of the inflow of corrosive capital which the region is facing. They should press for democratic progress, which is the real key to regional security and long-term stability, inclusive growth, and countering negative foreign influence. Based on the analysis I conducted together with the research director of ISAC Fund, Dr. Igor Novakovic, and in addition to the regional report presented by the Center of Study of Democracy, we made country-specific recommendations. And if you're interested, I can share this with you during the questions.

Thank you so much.

Mr. HAND. OK. Thank you.

And then, last but not least, we have Dr. Dimitar Bechev, who is at the University of North Carolina in Chapel Hill, I believe, but also a nonresident senior fellow at the Atlantic Council.

Dimitar?

Dr. BECHEV. Thank you so much. First of all, let me extend my warmest gratitude to the U.S. Helsinki Commission, as well to the Center for International and Private Enterprise. It's a great occasion and we need to have more of those gatherings to put the Balkans on the map, but also to discuss the region in—there's some broader processes and events. Russia is obviously very relevant on a number of counts.

What I'd like to do here, just to complement what Ruslan and his team across the region have done in terms of collecting the data and putting a lot of flesh to the discussion, is to give some general views on what Russia is doing in the region. It echoes arguments I've developed in a recent book I published with Yale University Press called "Rival Power: Russia in Southeast Europe." And I have three points to make. I'll be very brief, because I know you guys are itching to ask your questions to the team here.

First point is what Russia's strategy looks like in Southeast Europe, but perhaps even more broadly in Europe as a whole. And second of all, how Russian foreign policy squares with Russian business or corporate interests in the region and beyond. And finally, how Russian policies intersect with what regional elites, institutions, political players are up to domestically—in other words, the supply and demand. What is the demand for Russian policies in the region?

First of all, a lot of people discussing Russia almost come to this easy line: Russia is back to the region. Well, guess what? It is not back. It has been there for a long time. And much of what we discuss now is a legacy of the 2000s, when Russia was resurgent. It was—flowed with cash because of the high oil prices. And it was on a shopping spree in the region. Many of those privatization deals date back to the 2000s—the Beopetrol sale, even NIS in Serbia, the oil industry of Serbia that Nemanja discussed, Lukoil's expansion on the region.

But back then, Russia was having a much more cooperative relationship with the EU, in the early 2000s, even with the U.S. So economic profits and co-opting local elites was much more of an overarching objective than disruption. And I'd suggest that what happened with the Ukraine crisis is that Russia has shifted gears from co-optation or expanding its footprint to disruption. And you see it not just in the world of business, but more prominently in the world of politics with the Russian-affiliated political players, civic actors, political movements, media playing a role.

In the old days, Russia wouldn't argue against EU membership, EU expansion in the region. Now EU, along with NATO, has become a problem and challenge. So that's this shift of gears. Russia is pursuing disruption. The logic in Moscow, if I allow myself to think like Mr. Putin or his close entourage think, is we are under siege. The West is encroaching our near-abroad in Moldova, in Georgia, and Ukraine. Well, guess what? We can do the same in the Balkans, which is the vulnerable part of the West, an enclave that is not subsumed into NATO and the EU, and where we have traditionally our economic and political allies.

It's a tit-for-tat strategy. And as long as you maintain pressure on the Western alliance, you can have a bargaining chip in the greater dynamic between Russia and the

Western actors—the U.S., but also European allies. So I think that's my rough version of what Russian foreign policy is about, maintaining pressure.

Now, Russian business. Many of those people and economic agents, they're after profits. They're not necessarily proxies of the Russian regime. They came to the region because there are opportunities to make cash and to get assets, very often in untransparent ways. Some of them parked money because—in jurisdictions like Montenegro, like Cyprus, like Bulgaria, you could have the right conditions. Nobody would be asking questions about the origins of your money. And you could launder money. You have lots of people close to the regime, but also post-Soviet elites from other places like Ukraine, Armenia, and so forth, buying property, investing in Southeast Europe, in the Western Balkans.

But—there is always a but—the lines between foreign policy, the political establishment, and the business establishment are blurry in Russia. In other words, if you are the owner of, say, Lukoil, and you are summoned to the Kremlin, and you are reminded of how much your business depends on the good graces of the political leadership—of Putin and the people close to him—you will be giving back services. So all those business entities, although they might be primarily motivated by economic profit and gain, are potentially exposed to pressure from the state, and can very easily turn into elements of Russian foreign policy.

But it's constructive or disruptive, as I believe is the case right now. The formal—any formal in Russia, this boundary's always blurry. Many of the big political leaders are also prominent business people, and so on and so forth. So this ambiguity plays, and is very much present, in Russia policy in the Balkans. And I think that's reflected in the reports with very interesting detail.

Finally, supply and demand. We always tend to see Russia involved. But one thing that's really valuable in the research and the projects, and also—and I call it in my book—is very often we have to look at what are the local conditions that make Russian interference, Russian meddling possible? And very often in the sphere of economic governance you see lots of sectors that have been poorly managed, exposed to high-level corruption, political meddling. That creates the right conditions for Russia to throw its weight around.

And Serbia, being a very prominent country in the Western Balkans, provides the best illustration to me. Nemanja gave you some observations about Srbijagas. Well, Srbijagas has been a political fiefdom since the times of Milosevic, with different parties shifting. There is the intermediary company that charges some premium. And I could argue that this is a slush fund—and this is not a scheme that is not seen elsewhere in the post-Soviet space, but also in Eastern Europe—you could very well hypothesize that some of this money finds its way back into party coffers and buys political influence.

But the real root cause of the problem is why you have state monopoly, why gas is overpriced, why there's no competition or transparency in the gas sector. And you can envision a scenario—and I'm just moving here to the last bit of my remarks which is the political recommendations, where the Serbian energy sector and the natural gas is much more competitive, we have rival suppliers, where the final—the consumers and households and industries are given a choice. And actually, gasification of Serbia, which doesn't consume that much in absolute terms, might be a good thing, because it also will lead to lower carbon emissions. It's a problem across the region.

So what we need to have in the Western Balkans, but I would argue also in Southeast Europe, including countries that are already NATO and the EU, is much more robust reform agenda to ensure that sectors that are exposed to proliferation by Russia and political manipulation are scrutinized, are open to market competition and, also, you have a vibrant civil society, including think tanks and critical media investigative journalists, that break through the floor of those networks, and dependencies between local elites—be it business elites or political elites—expose the state capture that is providing the fertile ground for the Russians—or, for the Kremlin to interfere in the region.

Well, thank you so much.

Mr. HAND. OK, thank you. Excellent presentations from everybody here at the table. And it's made me think of several questions that I would like to ask as a follow-up. Looking out in the audience, however, I see quite a number of experts on Balkan affairs here today. And hopefully they'll be able to ask some of those questions for me.

I will ask one question to give people time to come to either one of the standing microphones. I'll ask my question and people can answer and then I'll turn to whoever is at the microphones to ask their questions. When I do, if you could please identify yourself and also state your affiliation. And then when you ask your question, if you could clarify whether you're asking it to a particular panelist or to the panel as a whole, or just one or two of them, however you see fit. But please clarify. And please try to keep your questions short and to the point. You can make a brief comment, but let me lay stress the word "brief," from the standing microphones.

While people get up and prepare to ask their questions, let me ask all of the panelists here a question, to the extent that they want to respond. You've talked about the threat to stability in the region that is posed by Russia's economic footprint. And you've expressed the views of civil society, I think probably reflective of civil society as a whole in terms of what needs to be done regarding the greater transparency, greater freedom for investigative journalism, perhaps judicial reforms and other efforts that would enhance the rule of law, and could hopefully tackle corruption. And these are very good things. And I think you have friends here in the United States and probably in Europe who can help in that regard.

But I was wondering if you could specify a little bit on how the political leaders themselves in the region see it, the ruling parties. Do they see Russia's economic footprint as a threat, or do they see it as something that gives them leverage that they can use vis-à-vis the West? Or are they somewhat oblivious to it? Are they actually personally benefiting from it? I assume that the answer will be different in each one of the countries in this regard, as well as to the extent which they each view Russia's economic footprint as a threat that determines how open they are to various reform efforts.

For example, I can imagine in Montenegro it's quite stark, the Russian influence. And now that it's a NATO member, there's serious concern. But has that made the Montenegrin government, Montenegrin authorities, more open to some of the fundamental things they need to do in their country in terms of transparency, rule of law? And I give Montenegro just as an example. I don't mean to focus just on Montenegro. I think it applies to all other countries. In Serbia I can see where there may be more of a balancing act. And in all of these countries, certainly probably in Republika Srpska, in Bosnia and Herzegovina, you can see how they can actually personally benefit from it or take advantage of it.

So I was wondering if you would like to comment on how the prime minister or president and the ruling party of a country might view the Russian presence in the region? And how does that shape their willingness to engage in these reforms that could try to lessen the malign influences that come with the investment from Russia, or from other countries that tie it to the political issues? Who would like to go first?

Milica.

Ms. KOVAČEVIĆ. OK. I can say that we had totally different situation 10 years ago. And probably, if I was doing this research at the time, it would be difficult even to gather the data. Even at that time, there was a criticism coming from investigative journalists, from media, over some concrete investments that later on appeared to be connected with corruption. Some of them are under investigation. For some cases there are already criminal verdicts, judgements. And the government was actually replying to us that the money doesn't have nationality and that we are stopping the reforms and stopping the progress. And I would say that there was no basic understanding of this phase that we are describing today, which is corrosive capital.

I have to admit that these things have changed. But I would say that we learned that a more difficult way. During the research—and I've been exchanging that with all the colleagues in the region, we really have the openness of the institutions to share all the available information and data with us—but what I believe is the most important is the recommendations that we are offering, that we should use this as a lesson learned and that we should fix these governance gaps in order that we are not surprised again in several years when maybe some other foreign country decides to use economic influences, leverage in political relations.

Mr. HAND. OK. All right. Thank you.

Ruslan, would you like to—make sure the light is on.

Mr. STEFANOV. Yeah, it says so. [Laughter.] Well, thank you for that question. And I'd like to address it also from the wider perspective of Europe. And I think it's one distinctive feature when you ask about these attitudes, the leadership of the countries, it's the silence that you usually get on this topic. And I think that speaks volumes. Of course, this has changed in the past year and year and a half. But I would say that this is the case also within Europe. And this—I fear that we will be witnessing this. And of course, it's not a secret that there are certain people also in Europe who like Mr. Putin's model, like the illiberal model, and that somehow hasn't been dealt with.

Now, if you look at the region, we've worked on the past five years on these topics, and including tackling very much governance and corruption problems. And one continues to see people that do not want their names appearing openly in the public. And I should say that in this regard, I'd like to mention that the U.S. role in the region remains indispensable, which is why we actually value very much, very highly Congress' and hopefully the U.S. administration's engagement.

But what we wanted to create with these reports is exactly this discussion space that would allow people to assess the size of the threat, the vulnerabilities that are out there. And I think it's exactly this type of diagnostics that actually should serve as a background for creating the—for designing the policies and the measures to tackle this footprint—or vulnerabilities of the footprint, including the entourage of Mr. Putin.

Mr. HAND. OK. Go ahead, Nemanja.

Mr. ŠTIPLIJA. Thank you. You ask about political leaders, but I want to stress something about citizens. Perception of citizens in past several years is that Russia is the biggest investor and biggest donor, at least in Serbia. So can you imagine, when—in recent surveys in past three years, we have this situation that citizens, on question who is the biggest donor or biggest investor in Serbia, it's always Russia in the first place, then China, and then Turkey. And reality is totally opposite. We don't have Russia in first 10 countries when we took account investments. So first is, of course, European Union, together with Germany and Italy. And then United States and other countries. We even have Japan on the ninth place, and Russia is somewhere below.

And the point that we need to have this role of media to think about these strategic economic sectors and to speak more about this influence and how this influence has happened. Also, governments should ensure that media outlets operate in safe environment, which is not the case now. And also, full access to data and information regarding these things.

Thank you.

Dr. BECHEV. Just a brief remark, both on the motivations of political elites and, of course, I'm generalizing because there are differences from place to place. But my impression is that the bulk of political elites are risk averse. I mean, we tend to think about Putin as a poker player. He makes risky decisions. Just the opposite in Southeast Europe, where people don't want to rock the boat, get into conflict with vested interests, or push too far against Russia because it might create blowback.

In the case of Serbia, there is an additional dynamic. President Vučić I think has encouraged his friendly media to inflate the image of Russia and its presence, it also reflects in the polling data, because it provides a very useful smokescreen. Anytime you cooperate with NATO and you build up the relationship with the U.S., that potentially is diverted by the media into how great Russian-Serbian relations are doing. It's a Machiavellian strategy of putting Russia first in order to avoid criticism over Serbia's dealings with the West and potential attacks from more radical voices, what Serbia is prepared to do in Kosovo as well, or is prepared to do with NATO. I think that's at play too.

But again, the question we should be asking ourselves is why governments in the region have managed to quell the media and silence critical voices, why they have all those subservient media outlets and there is precious little critical scrutiny in the public sphere.

Mr. HAND. Andrew?

Mr. WILSON. Yes, I think we have to look at this, too, in a broader political context, not just within the context of the governments in the region, but I think within a European context to truly understand this.

I don't think there really was a lot of concern from the rest of Europe about the nature of Russian investment or the scale of Russian investment in Southeastern Europe. But I think with the rise of euroskepticism within Central Europe, the questioning of globalist institutions that has occurred as a result of in the last two or three years, I think—and sort of the resurgence or the surge of both Russia and China, for that matter, filling a gap, whether it's the Russian move towards sort of this disruptive foreign policy or whatever, I think that's focusing people now. And I think that focusing by European governments on these issues is starting to force the attention of local political leaders as well.

I think it's probably—you know, has the horse fled the barn and we're trying to close the door—I don't think so. And I think there is certainly a rethink within Europe, because of things like Brexit, about the nature of European investment, the nature of European governance. And I think this fits into that broader debate in terms of rule-of-law issues and who's putting pressure where.

Mr. HAND. All right. So now you have had time to think of the questions you'd like to ask. Let me first call on this gentleman here, and if anybody else wants to ask a question, just feel free just to come up to the microphone.

QUESTIONER. Actually, I will make a short comment. I'm Igor Novakovic and I'm one of the contributors in the project run by the CSCE and CIPE. And I would also like to stress that there are other issues that local private enterprises are facing in Serbia, but also throughout the Western Balkans.

What actually makes these countries so exposed to the foreign meddling influence? I have a short list here and I will just read it: So there is an excessive state influence in the economy. Weakened energy and transport infrastructure. Inefficient markets. Only partially restructured public utility companies. Difficult access to finance; red tape; large, informal economy.

Of course, in Serbia, but also in other countries, employment is rising, but still large portions of the population remain unemployed and this especially affects younger population. So all of the states have a huge brain drain in particular towards the EU. And finally, state subsidies are usually directed towards the public inefficient and unprofitable companies instead of towards other objectives, like the small-to-medium enterprises and development and research.

Thank you.

Mr. HAND. Thank you. Does anybody want to follow up on what he said, since that was just a comment?

Mr. WILSON. I will. I think the reports highlight this already, but I think I would sort of just like to restress certain strategies that need to be put into place in this regard. And I think the NED in itself has been doing some very interesting work on kleptocracy, et cetera, about flows of capital once they leave the country. But our argument has been you really need to focus on, what are the conditions that allow the loss of money from state budgets and other things to occur? And focus on public procurement policy in the region needs to be reinforced.

Corporate governance, I think it was said in one of the reports, is very important, especially within the state-owned sector, to make sure that enterprises aren't politicized or bad decisions are made. Budget transparency—and, again, the importance of competition policy in this area, so these monopolies where they occur in energy or other things can be combated. And if we are able to introduce greater competition into the region, into the economies of the region, I think that'll go a long way towards ameliorating the influence of any one single economic player or group of players to shape political decision-making.

Mr. HAND. Thank you.

Paul?

QUESTIONER. Well, thank you all very much for this great panel. My name is Paul Massaro. I'm the anticorruption advisor for the entire region, a functional portfolio at the Helsinki Commission. And I had a question. It's rather long, so please bear with me.

In a number of countries surrounding the Balkans, we are witnessing the development of kleptocratic governance structures when corruption is used to ensure the loyalty of cronies as well as to influence the politics of neighbors and rivals.

The Global Magnitsky Act, which contains provisions to sanction individuals engaged in grand corruption, is a powerful tool for combating these sorts of regimes by enabling the United States to name and shame kleptocrats enjoying impunity in their own countries. Any such sanctions should be based on strong evidence and target individuals who are demonstrative of the problem so as to serve as a warning sign to others. To what extent are there states in the Western Balkans that could be described as kleptocracies or are on their way to becoming kleptocracies, which may contain individuals who would be appropriate to target under the Global Magnitsky act for grand corruption?

Mr. HAND. OK, thank you, Paul.

So the question is that of kleptocracies, but then also of the U.S. Global Magnitsky Act as a tool, in addition to supporting civil society efforts, reform in these countries to actually sanction offending individuals. Who would like to respond to Paul's question?

Mr. STEFANOV. I can take that.

Mr. HAND. OK, respond.

Mr. STEFANOV. Thank you very much for that question. Indeed, we have—we at CSD, together with other partners in the region, have been following as civil society the corruption and anticorruption developments in the past 20 years. And let me underscore that definitely the EU, including its current efforts during the Bulgarian and the Austrian presidencies, have made a difference. So we've seen corruption victimization, so the level of corruption and bribery in the region decreased. But it's still at levels that are systemic.

And probably the single-largest contribution and reason why this is so is the impunity that you have mentioned. Clearly, the judicial systems in the region have not been able to tackle particularly high-level corruption and links between politics and business, which is part of the reason why there's been the possibility of such corrosive capital to enter in the region and to actually exert its bad influence.

So we think that—and what I mentioned earlier—that the Magnitsky Act is a really powerful and needed tool. And that I think that our reports and the reports that we've produced both for the region, Central Europe, but also the individual reports are a very good starting point as a background to not just target individual politicians or rotten apples, as we say, but give a wider perspective as to the needed policies. And Andrew just mentioned a number of them that we think need encouraging.

And I think that this year we're going to see a lot of that coming, you know, with the renewed European strategy for enlargement. And hopefully we'll see more and more focus on the issues of good governance.

QUESTIONER. Could I just follow up and ask for clarification? Would you see the targeting of a basket of individuals emblematic of the impunity enjoyed by corrupt actors in the region as a helpful move or as an unhelpful one?

Mr. STEFANOV. I see it as a helpful move as part of a larger basket of policies. And definitely, I think we've seen this in the past, we've seen it act in the previous European enlargements, we've seen it in the case in Ukraine. So, yes, the short answer is yes.

Mr. HAND. Andrew?

Mr. WILSON. Yes, just a couple of thoughts. And I completely agree with what Ruslan has said. I think one of the issues I've got is, how do you define a kleptocracy? And I think a lot of people have been kind of struggling with this. How do you separate a kleptocratic state from something that's just very, very corrupt?

And I use a loose definition that, if by some means you're able to wave a magic wand and corruption went away immediately, could the state still function within its economic and political structures? I think you could make the argument, if you waved your magic wand at Russia, the state would probably collapse. Corruption is the way of life and business in Russia. I'm not so sure states in the Balkans are corrupted to that extent. Certainly, we have a lot of corruption, but I would fall short of calling them kleptocratic states.

That being said, I think the power of the Global Magnitsky Act and the ability to sanction individuals is a very important part of a broader anticorruption strategy. But I think, while we may be able to single out individuals in a region to say, you know, you're a thief, you're doing your country bad, I think we also have to put pressure on groups like the EU to step up and say, OK, you're doing wrong, what can you do right? And I think, frankly, the EU is awash in its own problems right now. But I think if you look at what they've done with Article 7 in Poland and the issues with the judiciary in Poland where they have finally put the foot down and said, OK, no more of this, I think to the extent that we can—if we could encourage the European Union, which is one of the largest investors in the region, to put its foot down and to say we're not going to tolerate this anymore—and by the way, the individuals on these lists are ones we're going to watch closely, too—would be very helpful.

But if we don't have a strategy that addresses both the policy remedies and the criminal approach, we're only—naming and shaming will only get you so far.

Mr. STEFANOV. Well, let me just say that I completely agree with Andrew on the kleptocracy thing. I don't think any of these countries could be named as kleptocracies. But there are certain sectors, there are certain sectors, there are certain trends that have been visible and that could be labeled as kleptocratic trends or kleptocratic deals, you know, and we've mentioned these in the reports. You know, looking at the energy sector in particular, looking at large scale infrastructure projects.

And actually the EU—you're right, Andrew—the European Commission actually, I think, is trying to put its foot down, like mentioning in its last progress report on Macedonia, for example, that there are certain trends, certain areas that look like a captured state.

We've certainly had—and I think Dr. Bechev mentioned the captured media—that's a huge issue and needs to be tackled effectively.

Thank you.

Mr. HAND. Anybody else like to make a comment before we go to the next question? No?

Ma'am?

QUESTIONER. Hi, Robin Brooks from the State Department. And I'd like to thank the organizers of this conference and all of the speakers for very interesting reports.

I have a question that I'll start with, and then give some background and then ask again. My question is to Ruslan.

In the first Q&A, you mentioned that the U.S. role is still critically important. And I want to ask you what the U.S. should do—and I say this as someone who, as you know, has worked in the Balkans and will work in the Balkans again. What I think the U.S. does do is say things like, hey, don't do that Russian project, instead take this American project, and say, hey, don't violate sanctions or more sanctions, Global Magnitsky. But I think what we haven't done very effectively is request and demand an interest-based, transparent approach. You know, why do you want a nuclear reactor? Why do you want this project? Why are you having a tender for this infrastructure project at all? Explain to us and your own people why you need it and where the money needs to go.

And I think there's—you know, there's two interests here at stake, right? There's if—and I think every single one of the speakers mentioned debt as one of the most important ways that Russia maintains its influence in the Balkans. If you're indebted to Russia, they can't kill you, right? Venelin Ganev said that in his book "Preying on the State." They can't kill you if you owe them money because they have to wait for you to pay them back and you never will. So there's a very strong interest in choosing the Russian project so they can't kill you.

But what can the U.S. do to make the U.S. project make more sense? And I think Ruslan and also the first questioner had some good points about sort of the background that builds resilience—you know, a strong education sector and health care sector that reduces brain drain and causes good people to stay in a country and actually hold their government accountable and be journalists to hold their government accountable for journalists' safety and so on.

So what more could the U.S. do to actually make a difference beyond sort of contributing to think tanks and saying, hey, don't get in bed with sanctions?

Mr. STEFANOV. Thanks, Robin, good to meet you again. Let me underscore that I think both the U.S. and Europe have done a lot to improve transparency in the region. And that cannot be denied. And we've had, with CIPE and Andrew, countless discussions in the past three years about corporate governance, about the facts of capital that's coming from Europe or the U.S., about improving the local business environment so that this capital actually delivers to the people and that also the democracy and institutions that we have been building actually deliver to the people.

And I think the real question is that, as I mentioned, the silence among the leaders. You know, there is—people have never been shy to discuss certain deals in which the U.S. or European countries, European investors have been involved, including in cases of Foreign Corrupt Practices Act and so on and so forth. But Russia appears as the elephant in the room, you know, nobody wants to speak about it for some reason.

Now, when—and I think there are a lot of issues that have been discussed in terms of potential policies. You know, one is, I already mentioned, I think, the focus on media capture. That is definitely something that we need to do.

Andrew already outlined a very good list of policies we've had. I mean, one sees the difference between, for example, Bulgaria and the Western Balkans in terms of the level of transparency. And that has also affected the European Union integration that is much higher in Bulgaria.

But at the same time, you look at certain, we call them switch projects, like, for example, the interconnectors in the energy sector because energy is critical. You know, like the IGB interconnector in Bulgaria or like the Bulgaria-Serbian interconnector. These are very straightforward, very clearly beneficial to the countries and to the people and to the prices they're going to pay. And yet, they don't happen for some reason. So I think these are the switches that the U.S. and the EU could help push a little bit forward.

And we could—we could talk, of course, in many more different such aspects, but I think this gives an example. You know, we keep—I think there has been a lot done on the overall environment on transparency, on the capacity-building of public administrations and on keeping that pressure in a way. I mean, I think somehow with the EU accession we've been somewhat complacent, saying that once a country is in that's it—[inaudible]. But that's not the case. Actually, I think people in Europe start realizing that it's a constant work that we need to deliver.

Mr. HAND. OK.

Dr. BECHEV. Yes, the U.S. has one advantage that it has more of a strategic approach. It's a nation state. What we have with the EU is very often speaking with different voices. All those governance issues, the pressure for human rights is sometimes outsourced to the European parliament which ends up being a huge talking shop. And there are very good people there and they say the right things, but when it comes to the nitty-gritty, it's the member states who decide and very often it's the lowest common denominator, it's always the same, you know, it's worse.

When the U.S. speaks, for all the dysfunctionalities you sometimes encounter, you have more of a unified voice and pressure. So America carries some weight in the region still—that's important on this score.

And just to echo what Ruslan said about the energy sector—energy security has been high on the radar of U.S. diplomacy, but it's the State Department's policy, there is very little by way of private investment to follow up. So U.S. diplomats pursue some objectives, but it's very rare that you see private business prepared to invest there, which is probably fair from their perspective because the profits are not short term. You have to make a case for the economical nature of those ventures. But that's where it's lacking with the U.S. approach, the money, which Europe does have, but it doesn't have the vision.

Mr. HAND. Sir, go ahead.

QUESTIONER. Hello. I'm from the House Foreign Affairs Committee, and I have a question for all of you.

You've talked a lot about the extent of Russian meddling in the West Balkan region. You also mentioned earlier that China and Turkey were putting corrupt capital into these countries. Could you talk more about specifically what these two countries are doing in the region and what are some tangible effects of their influence?

Mr. HAND. Who would like to start on that one?

Andrew?

Mr. WILSON. I think we need to make a distinction, first off, between types of corrosive capital, if you will. So if we look at Russian capital and the way it's tied to foreign policy objectives as opposed to maybe easy capital, you know, which might be something from Turkey or others, which is just capital, in our minds, which tends to flow into high-risk environments, the nature of the investment becomes much more short term and it's quicker to flow out. It's not the best kind of capital you can get, but that's a premium for being in a high-risk place.

If I was to look at, say, Chinese projects in the region, the Chinese were able to buy the Port of Thessaloniki a while back and it's part of their Belt and Road strategy. And

I think if you look at the construction of the railway line, the proposed railway line through Serbia into Hungary to link Thessaloniki with the European rail infrastructure in a better way, that's one area.

Should we look at how that deal was made in Serbia? The Hungarians, because they're under EU policy, have yet to commit to building their stretch of the track. But I think we could look to say, what was the nature of the deal that's getting the dual tracking being built in Serbia as part of that.

You know, Chinese investment, Chinese aid, Chinese projects are a completely different area of focus, one we're working on as well at CIPE, you know. But I think, you know, the questions need to be asked. The same types of weakness in government that allowed in the 2000s Russian investment in private enterprise or privatization in the region are the same basic weaknesses that we're seeing now that might allow governments to take dubious loans from the Chinese or allow dubious construction projects.

Frankly, you know, Chinese financing and Chinese foreign aid is kind of like the payday loan version of lending. You know, you can take a lot of risk there, they'll take a lot of risk with you, but when it comes time to pay the debt you're collateralized and they'll seize it. And that's how doing deals with the Chinese is very different from doing deals with, say, the World Bank or the IMF when it comes to these types of aid projects. And I think there's not enough scrutiny in regards to how these deals get made in the first place.

Mr. HAND. Thank you.

Somebody else would like to speak on China, but also Turkey? And I would actually add also the presence of Gulf states from the Middle East to the extent that they can be compared and contrasted to what we're talking about in terms of the Russian economic footprint.

Dr. BECHEV. Maybe just a word on Turkey. There's a spectrum of Turkish investment over the past 25, 30 years, all the way from small-medium enterprises based on diaspora networks. I mean, let's not forget that Turkey is not exactly an external power. Just look in a place like Sanjak in Serbia and Montenegro, how many of their relatives live in Turkey and there is human connectivity. So there is that. I mean, it's money.

There is a vibrant business sector as well, so some of the investment is always—also may be beneficial. But certainly, there is politically correct capital, especially in the construction sector with the AKP government. All those people have made money because of their proximity to Erdoğan and his family, so we're likely to see those.

But I think the dynamics are more in the mold of the Turkish state lobbying for its investors to get market openings relevant to seeking to employ economic connections to push governments in one direction or another. So I think there is something different between Russia and Turkey. The Gulf is a different story as well, somebody might want to comment.

Mr. HAND. Milica?

Ms. KOVAČEVIĆ. It wasn't part of this very research, but actually the patterns, the problems, the governance gaps can also apply to some other investors as we see in civil society. And I would agree with Dimitar what he said on Turkey, but I would say that civil society, at least in Montenegro—but also I'm talking to the rest of the region—is recognizing the problems that we recognized 10 years ago with huge Russian investments, now with the Chinese investments, especially because they are using the same ways—

like, for example, bilateral agreements to avoid public tenders, to avoid Freedom of Information Act. So we are ending up like it was back in 2005 and 2006 with Russian investments without knowing what's behind these deals. So we don't know now and I can't say anything about that.

But I'm hoping that we will continue working exactly on this, and not because of Russia only, but because of all the potential risks and, you know, we are endangering our economy by not knowing about these important problems.

Mr. STEFANOV. Just very, very briefly. As Milica said, this was not a focus of our research. I'd say the worrisome thing is the integration between politics and business. And if—and this is clearly—I mean, Russia, in this respect, has presented the most assertive threat in the past years. But if there's one country that combines the same level of control over business and coordination of political strategy, that's probably China and we've seen this. I mean, talking to stakeholders in the region, we've seen this worry of similar impacts.

But the real issue is that we don't know—really know—what are its business opportunities they are after, or rather, the suspicion is we don't really know what their political goals might be. So, again, this is my take on this.

Mr. HAND. Thank you.

Sir?

QUESTIONER. Hi. I'm Marko Durovic, I work for a congressional office here, but I lived in Belgrade all my life.

I don't know where to start. And I'm sure you feel that way, too, sometimes. But I guess the first part would be about the media. And I feel like the media at this point is essentially state owned, except for maybe N1. So how do you put pressure on the government to move away from that? Because without an impartial media there's no way to change public opinion and public opinion is not in favor of what people in this room think should be the solutions.

And then secondly, how do you put pressure, in general, on a government that that is playing this balancing act between the West and the East and that could, if you put too much pressure on them, they might go further towards Russia than you would like and that could lead to some even worse problems? And I don't know—I have so many questions that I could ask.

Mr. HAND. Well, why don't we get answers to those and then maybe we can go to a round two.

Mr. ŠTIPLIJA. So basically, the media situation has become very complicated from 2012 in Serbia, but, you know, throughout Western Balkans, especially, in the first place, in Macedonia was the worst example. Media are not owned by the government, but just influenced by the government, so it's very, very, very big topic. Like, if we speak about how government influences media through advertising to controlling some other aspects or their work, et cetera, et cetera, even controlling owners of media.

In Serbia, this is several, of course, free media. And maybe for some part of civil society it's the only way to influence. But still, influencing through just media cannot affect the broader population. That's true.

QUESTIONER. Exactly. Sorry. But I think that a lot of the population literally looks at television, like N1, and thinks, oh, American propaganda. And I've heard this because I'm——

Mr. STEFANOV. Yes, yes.

QUESTIONER. So how do you practically change that? Because there's a lot of solutions that in theory are great, but there's just too many powerful actors with no real incentive to change the status quo.

Mr. ŠTIPLIJA. You know, like, we try to work with the, in the first place, European institutions, through the—because in this stage of enlargement we have something which is called Chapter 23 and Chapter 24, which are chapters dealing with basic rights and also the rule of law and, at the end, media freedom. So by—and these are crucial chapters for Serbia and Montenegro in this phase of European enlargement. So pushing the government through this is one of the things we do.

Mr. HAND. Ruslan?

Mr. STEFANOV. There are no silver bullets. And I understand how you feel. And we've been facing this situation time and again, but we're very positive about the future, you know. And there is one kind of unique disinfectant and that's sunshine. You know, knowing the ownership structures and not allowing concentration is the good old principle of not having a monopoly on media distribution or media ownership and, of course, knowing who owns the media. Because in many cases in the region and actually throughout Central and Eastern Europe, you don't exactly know who owns—who's the official owner of the media and how they respond to the different ethical standards that are in these countries.

So I think it won't happen overnight. But at the end of the day, a combination between, as Nemanja said, the European integration process, local civil society, including through an approach like this, you know, where you create this discussion space, you create the opportunity for other people to contribute, and I think this is the way forward.

Thank you.

QUESTIONER. Yeah. Thank you, Bob. My name is Reuf Bajrovic, and I'm the former minister of energy in Bosnia and Herzegovina. I really didn't want to say anything, but I have to just make two short comments and ask a question for your excellent panelists.

First is a response to the question by the gentleman here about the Chinese. The Chinese are extremely interested in the energy sector. They have lined up two very big investments in Bosnia in two thermal plants. They love coal, as we all know, unfortunately, and there's a very good possibility that they'll do the same in Montenegro, in Pljevlja actually.

They're doing a number of other things. Their influence, unlike the Russian influence, is far more under the radar and, in many ways, I'd say a more strategic one. They have a much—in my view, their window of sort of how they view their investment is much, much more—much longer.

Regarding the corruption, I was very surprised by Mr. Stefanov's response, because as somebody who actually resigned because of the endemic corruption, it is my impression that, I mean, we're dealing with probably the most corrupt countries in Europe. I mean, I could be wrong. I've never actually worked in Russia in any capacity, but corruption is absolutely everywhere. And since the U.S. has essentially sort of let the Europeans take over the region, as we used to call it, "lead it from behind," you know, in the last several years, at least seven, eight years, corruption is not really something that people want to deal with.

The judiciary is completely penetrated by the ruling parties. And there's absolutely—and my view is that the Magnitsky Act can do more good to the Balkans than probably any other part of the world that I know of. Because unlike other big countries where, you know, if you really, as the gentleman there said, if you push too hard, they might go in the very wrong direction, I think in the Balkans it would actually make a difference if some of these people were actually named and shamed.

And the EU, in my view—I hope that I'm wrong—the EU is not going to do it. I mean, the EU simply, for example, refused to impose sanctions on Mr. Dodik after the U.S. did last year, because the EU just doesn't want to, as your panelists have said, doesn't want to deal with the region, period.

My question is for the panelists. And it is, do you—is the—I've read the report and I think the reports are excellent. I've read every single one of the papers that you've been publishing them consecutively. Do you actually—what you don't say there and what I would like you to share with the audience here—do you think that the Russians are getting a good return on their investment in the Balkans, because nobody really wants to talk about that, you know, people say they don't make profits, they don't make money. But overall, do you think that the money they're spending is, from their point of view, a well-spent dollar?

Thank you.

Mr. HAND. Thank you, Reuf.

And before we turn to his question, I'd just like to reinforce the point that he had made in terms of initiatives the United States can take in terms of sanctioning individuals, but that we certainly need the support of Europe which is currently very much unwilling to do the same type of thing. If there was a united front in that regard, I think it could make an enormous difference in the region. So I just wanted to reiterate that.

But return on investment for Moscow, who would like to start with that one?

Ruslan? I always go to you first. You're always ready. [Laughter.]

Mr. STEFANOV. No, I can actually respond because it was a direct comment on what I said. We actually have in the regional report, that you can download at CSG.bg, we have this perspective. And indeed, Bosnia and Herzegovina is the one country from the four that has stayed above the regional average in terms of corruption and victimization, so probably your feeling is right.

But at the same time, we've seen a decline in the past 20 years and that we have registered through a victimization strategy. And I also have brought here a couple of copies of "Shadow Power," a regional report that I can distribute.

But let me say that the level of corruption indeed that we're seeing and I mention is really systemic and it requires further concerted action, including, as you mentioned, through the Magnitsky Act at the highest level.

Now, we've also wondered about a return on investment, but then you have to acknowledge as to how does an investor define that return on investment, whether it's just the monetary value or whether it's something more. And I should say that if you look at the—in the number of cases that we've looked into, profit is not usually shown on the balance sheet. So if you look at just the numbers, probably the answer would be no. But the question is, are we certain? And rather, we'll say we're certain that this is not, in many of the cases, this is not the ultimate or the only criteria that the investors themselves are looking into.

So I should say that that's exactly the point that we're making, you know, that return on investment and how the investor feels, it depends on their goals in the first place. And we're not sure actually, sure that in many of these cases it has not been entirely commercial.

Thank you.

Mr. HAND. Dimitar?

Dr. BECHEV. Yes, I guess the answer varies from place to place. In some cases, there's been a lot of betrayed expectations. When Oleg Deripaska bought into KAP, he was counting on continued support and subsides from the Montenegrin Government, so his accounts didn't prove right. And, I mean, ultimately, he was burned. And that's his perspective, I'm sure.

In other cases, if you think about the NIS sale, they have very different accounts. The Serbian viewpoint is that they sold their family silver to the Russians and didn't get much back. The Russians will say that we bought an underperforming company with a lot of liabilities and hidden problems that we needed to sort out, and we did the Serbians a favor, but there is no way to bail out now. And what we wanted to get at the end of the deal, South Stream, didn't happen. So it doesn't—or it's not very clear what the balance is.

But you have, certainly, cases where Russian businesses with political cover, or *krisha* in Russian, did very well. I guess Macedonia might be a case. Mr. Samsonenko has a thriving gambling empire being in cahoots with the previous government, and I'm sure has connections with the business establishment.

So I think the answer varies from place to place and from business to business and there is a whole new level when it comes to geopolitics. My gut feeling is that—yeah, I mean, and the other thing is some of the people involved in those deals, packages, geopolitical, have their personal interests at stake. Gennady Timchenko, Stroytransgaz, involved and on the sanctions lists, I should add, involved in South Stream, he has done very well. Even if the project was canceled, the amount of services he delivered to South Stream and construction, but also pipes have generated profit. So at the different levels, the geopolitical level, the business level, but also the state capital level, the answer varies from what is the dimension you are looking at.

Mr. HAND. Anybody else?

We have time for one more question if there's anybody out in the audience who would like to come to the microphone. OK. Or we could do two if they're quick.

QUESTIONER. Hello, everyone, Boris, Macedonian Information Agency.

I just wanted to ask about or focus on the Macedonian report, on the report from Macedonia. You guys have put scrutiny on the energy sector, basically, but we—I don't see any other parts of the economy, like investments of the Russian capital in, for example, in food sector or agricultural sector, because I have information that the Russians are investing in these sectors as well, as well as in real estate. So have you seen—have you—do you know any information about that? I mean, I have information that Russian security services, individuals from Russian security services, they used their capital, they are getting capital to invest in these parts of the economy. So maybe you have put this perspective more on the energy, and why is it like that?

Mr. HAND. OK, thank you. Why don't we go to this side and ask both questions together?

QUESTIONER. Thank you, Bob. I'd like to salute Bob Hand today for his longtime involvement.

Mr. HAND. If you could identify yourself, please.

QUESTIONER. Yes, sorry. Joe Foley ?

Mr. HAND. Before you salute me. [Laughter.]

QUESTIONER. Giving out the accolades early. But I'm Joe Foley with the National Federation of Croatian Americans here in Washington. And I wanted to thank Bob again for his longtime expertise in the Balkans and for his excellent assembly of this expert panel on the basis of the commission.

The Croats in Bosnia are the smallest of the three constituent peoples as designated by the Dayton Peace Accord, as we all know. The NFCA has viewed Bosnia as a frozen state for some time and that the current and future treatment of the Croats in Bosnia is and will be an indicator of the success of this new nation state. In other words, the treatment of Bosnian Croats equally along political, economic and religious lines, this matter remains an Achilles heel in Bosnia and, in effect, the Croats and their equal treatment may be the glue that will hold the Bosnian nation state together.

Does the panel agree or have additional thoughts on this? And will Russia continue to pick at this seeming political scab via the statelet of Republika Srpska and/or in the parallel statelet of the Federation? Or should we be more worried about Turkey in Bosnia?

Thank you.

Mr. HAND. OK, thank you.

And there's one last question that we'll add to this group and then I'll ask each of the panelists if they want to answer the questions, but then make a quick concluding remark, then we'll wrap up.

QUESTIONER. Yes, well, that will be my question actually. Good morning, everyone. I'm Jovana Djurovic, a journalist from Serbian service of Voice of America.

So my question is basically, what is the conclusion—what could U.S. and EU do towards decreasing this malign Russian influence? Because we have heard a lot of times on hearings like this that there should be a stronger engagement. But, you know, regarding this economic influence, which is very concrete, we are talking about money here, what could be done instead of, of course, what has been done already in terms of fortifying civil society and, you know, justice?

Thank you.

Mr. HAND. OK, we've had three questions: just to summarize, not do them justice, but to summarize the questions—sectors other than energy, the issues in Bosnia, and then, again, the U.S. and what it can do.

Why don't we start, go in reverse order from the way that we started and you can make any concluding comment that you want as well. And we'll start with Dimitar.

Would you like to make any comments on any of these things?

Dr. BECHEV. Well, just to say a few words about Bosnia that we sometimes assume that the Russians are bound by their alliance with local Serbs, Serb nationalists. But in reality, Russian foreign policy has been very versatile. There are no commitments, no permanent allies. They can do business with pretty much everyone, so you could see with the change of tone by Croatia's president, Ms. Grabar. Mrs. Grabar-Kitarovic, so she is one of the people who argued that Russia was waging hybrid warfare in Bosnia. But since, she has softened her rhetoric, she went to Sochi, had a face-to-face with Mr. Putin. I think Agrokor made a difference.

And in order to disrupt U.S. policies, I think the Russians are prepared to align with extreme factions of Bosnian Croats as well, without going as far as upending Dayton. So, yes, the Croatian issue is crucial, but my sense is that Russia can exploit this line of confrontation as well, if it suits its interests. And we have to be mindful of that.

Mr. HAND. Milica?

Ms. KOVAČEVIĆ. Oh, I think that Jerusalem can provide Macedonia and Bosnia answers for this question whether the EU and the U.S. can—I mean, we have been frequently asked this question, and—obviously it's not a simple answer, and it requires a strategy for this region. And I am actually happy to hear that there are some developments.

So I will just try to be as simple—though I will say that the U.S. should continue what it is doing right now because, for many years before I was screaming and yelling at my friends from Western Europe and primarily from the U.S. that once they lost interest to the region, once they got out, the gap was left, and the vacuum couldn't stay because we are not in the space because there is always someone to fill in that gap. And, unfortunately, we were—for all the mentioned reasons that include both good governance—well, actually deficiencies of the governance and poor economy, we were not always able to really be choosy.

But this new engagement and diplomatic presence and efforts in the Western Balkans, I would—civil society in the Western Balkans really looks at that hoping that it can help because we already see that it is giving some motion to the processes that were quite stagnating due to the different reasons in Europe.

Mr. HAND. Ruslan?

Mr. STEFANOV. Thank you.

On Macedonia, this was a country that was most difficult to get data from, so—and many of the investments there come from offshore jurisdictions, so there wasn't a way to actual verify whether they were actually with Russian origin or not.

So that would be my answer on Macedonia, and we'll continue this as a pilot—I mean, we'll continue to research that, and as information becomes publicly available, would be able to of course deepen and expand that analysis.

On Bosnia, I'd like to underscore that the real issue that we're looking at is our governance gaps. I do not think that Russia or anybody else that wants to exert malign influence would look at the really historical or cultural links. I would rather—we would rather think—and this is what the research shows—that they are actually using any governance gap that they can, and in that respect, they could actually—as Dimitar mentioned, could go into any different kind of—through any different channels—channel of influence.

Now—and final remarks—I think with—we have a more detailed section on recommendations in each of the reports and also the regional one. I would like to underscore, again, that we think that the U.S. remains the indispensable nation for the development of the region. We think there's been a very good development in the past year, and Congress has been leading that on the side of the U.S. We think that the EU is also increasing its focus on the region, including on good governance. We've seen that in the past.

We would like to see a little bit better kind of joint voices on the side of the EU from the different from different EU institutions like the Commission, the Council, the delegations on the ground, the different political party families—would like to see a coherent message. I think that the real issue with the EU approach has not been the approach itself or the amount of time or focus that they spend, but the coherence of the message, and we hope that this will continue to improve in the future.

So, with that, I would like to conclude.

Mr. WILSON. I'll comment on the question on land ownership in particular. I'm personally not as troubled about land ownership as I am about other assets. You know, land is not going anywhere. You might own a piece of land, but it's not like you are going to take it away to Russia if you don't get your way. It's stuck in the country. It's a fixed asset; therefore, your ability to influence of land ownership I think is a little more restrictive.

And I think we also have to look at why are people in the secret services, for instance, buying land versus the other nature of Russian investment in, say, energy sector. I would posit that if you are buying land somewhere—if I'm a criminal buying land somewhere and I reside in Russia, I'm essentially trying to move my money to someplace where it's more secure. My intention there is to get it out of the country. It's not to try and influence a decision made elsewhere, whereas buying a stake in a gas company is something that you can directly use for political ends in the longer term. So I think you need to distinguish between the types of ownership.

In terms of final thoughts of—you know, I think why we haven't been talking about this more and investigating this more is that I think this idea of corrosive capital is not one that people have paid a lot of attention to until recently. And I think we all are just starting to understand, as we start looking at these connections between governance failures and governance weakness and the nature of investment, that we're starting to put these pieces together.

So if we're going to move forward and have an idea about, OK, what do we do about this, I think I'd go back to what Ruslan was saying earlier about sunshine. I think the better we understand things, the more information we can get to the public that helps people draw the line between investment decisions being made or accepted and the potential outcomes—whether it was the decisions on South Stream or something else.

So we need to understand the nature of ownership. We need to point out the nature of the consequences of this type of ownership—you know, this investment was made and it was used to influence a decision here or there—and then to say what are the policy remedies that need to come from this. That doesn't necessarily mean that the United States or the EU needs to shift its policies or reinforce policies. I think that what that really means is we need to encourage groups like these at the table to undertake this kind of research. We need to enable them, civil society, independent media, and others—and I think it has been said here at the table—to start looking at this as an issue. And that's certainly what we, at CIPE, are trying to do. It's not to really, you know, in single cases try to point these things out, but to say, hey, look, there's a connection here that needs to be made. There is a cause and effect here that's out there, and we need to better understand that, especially because of the changing nature of globalization and how the economy is working in the world, and the nature of how norms, moving forward in the economy, are going to change.

Corrosive capital is here. It's not going to go away. So the issue is how do we provide governments and people in emerging markets with the tools they need to understand the potential impact that's going to have on them, and I think we have a lot more work to do in trying to understand the basic nature of the problem, in the first place, and then to understand what the policy remedies are moving forward.

Mr. HAND. OK. One additional person has come up to the microphone. I never like to say no, so I'll allow the question. But after Ajla's question, the microphones are closed and I'll conclude the briefing.

Ajla?

QUESTIONER. Thank you, Bob. I'm sorry, everyone. This will be very quick.

My name is Ajla Delkic, and I'm with the Advisory Council for Bosnia and Herzegovina. We advocate for a united multiethnic and democratic Bosnia.

My question is for Dr. Bechev. Why is the Croat question crucial when it comes to Bosnia? Would you not say that—well, first of all, Croats have equal rights under the law given that they are one of three constituent peoples, according to the Dayton Peace Accords. And it's actually Bosnians themselves that would be the more crucial question because if you identify just as a Bosnian, you can't run for presidency, as we all know. And another question is, my colleague, Mr. Foley, talked about Russian and Turkish influence in the region, in Bosnia in particular. But what about Croatia's influence?

Those are my two quick questions.

Thank you.

Mr. HAND. Quick response?

Dr. BECHEV. I need a disclaimer of amended—the kind of dynamic between Croats and other groups. It's important, which doesn't mean to say that other questions are not equally pressing in Bosnia. Unfortunately, we have a whole list of concerns and the so-called Croatian question might be one of them, along with many.

On Croatia, I will just say it—absolutely its role is important because at times the governments since I grew up have played constructively, Bosnia has benefited. And sadly, when they played a disruptive game, consequences haven't been good for Bosnia, but arguably also for Croatia.

I'm not as concerned about the role Turkey plays in Bosnia because, I mean, there is this claim that Turkey is reconquering the region, having new Ottoman ambitions, and what I see in the Turkish case—and that is the last thing I will say—is that they have actually downscaled their objectives because their foreign policy is elsewhere, their concerns are elsewhere.

Back in the day, Ahmet Davutoglu wanted to be the power broker in Bosnia. He didn't go very far. Nowadays, it's Izetbegovic and Vucic going to Istanbul to talk to Erdoğan to resolve their issues, but I guess the message from Erdoğan is, you guys sort out the issue of the highway yourselves. Turkey will probably support you, but we're not there to knock heads.

And think about it. Now Serbia thinks that Turkey is an ally on the issue of where the highway should go through. It's a reversal. Belgrade thinks that Ankara is on its side, not on the side of Sarajevo, which tells us that things are not fixed in the region, and there are new phenomenons, new processes at play.

Mr. HAND. OK. Thank you.

At this point let me just wrap up the briefing with a comment or two. A lot of specific recommendations or suggestions have been made here. The thing I take away—and I hear this other places where the Balkans are discussed in Washington—is that, on this issue as in so many others, the United States does need to play a leadership role, and by leadership role, it's not lead by behind, as Reuf Bajrovic said, but also to take some initiative and to promote some of the things that have actually made this country as good as it is: individual enterprise, openness, transparency, accountability. We have our faults, but we try very hard, and we also try to correct the faults that we have as we promote some of those things and be more active and engaged in the region.

And it's not just in the economic realm; I think it is across the board. Looking at some of the larger political issues, having followed the Balkans for 30 years now at the Helsinki Commission, the United States has always championed those that are vulnerable, whether it's the populations as a whole, this or that ethnic group, or this or that country in the region, to make sure that everybody shares in a brighter future. I think that would apply in Bosnia and elsewhere, trying to preserve the equalities of the people at the same time promoting what is an American ideal of stressing individual human rights over collective ethnic privileges generally.

I know some people in the audience will probably say, here goes Bob again, but it's something that I think we will continue to need to advocate, to push for alternative ways of thinking than the way so many of the people in the Balkans have been thinking over these years, and to realize that there's alternatives to those ways. So I take that away from this briefing, and I think the Helsinki Commission will continue to maintain its focus on the Balkans and pushing these issues throughout the rest of 2018.

Let me just conclude by again thanking the Center for International Private Enterprise, CIPE, for bringing our panelists here. I'd like to do a specific thank you to Martina Hrvolova for helping with this. Martina and I, I think, first spoke about this subject a year or so ago, and I said I'd love to have a briefing on it, and CIPE has delivered very, very well in helping me do that.

I'd like to also thank Lauren Meyer and our interns at the Helsinki Commission who came over here and got everything done. After 30 years, I'm more nervous about organizing one of these things than our interns, who just started this semester. They just get it all done very well—thank you—and let me thank as well Stacy Hope and Jordan Warlick and my other colleagues at the Helsinki Commission who helped make this happen, get the word out and make sure the room is set up the way we want, correct it when it's not, microphones working, and recording it.

I should mention this has been live streamed, and it will be available on the commission Facebook page and website, as well all the written submissions. I'll include the statements that were made today as well as the reports, and there will be an unofficial transcript originally, but then it will be printed in a final form.

And I hope to see you all again at a future commission event, and enjoy the State of the Union address tonight—[laughter]—and have a good day. [Applause.]

[Whereupon, at 12:03 p.m., the briefing ended.]

A P P E N D I X

Prepared Statement of Andrew Wilson, Managing Director, Center for International Private Enterprise

Chairman Wicker and Co-Chairman Smith, Distinguished Members of the Committee, Senate and the House of Representatives,

Good morning. My name is Andrew Wilson, and I serve as the Managing Director of CIPE, the Center for International Private Enterprise.

I wish to begin by thanking Bob Hand of the Helsinki Commission for his leadership on this important initiative, and welcoming the participants and attendees of this timely briefing.

Over the past decade, there has been an increase in the flow of funds from a number of non-democratic countries into emerging democracies. While in many cases, this might represent wholly legitimate investment, in other cases, there are signs that governments have specifically sought to direct this capital, to achieve purposes other than purely economic.

At CIPE, we define this issue as "corrosive capital"—equity, debt, and aid that both takes advantage of, and exacerbates weak governance in emerging democracies, to the detriment of their democratic and market development, as well as to influence their geopolitical orientation. Corrosive capital can distort policymakers' incentives and decision-making, privileging the political influence of foreign governments over local citizens' voices.

CIPE welcomes the partnership with the Helsinki Commission, and the opportunity to present today these knowledgeable panelists, who will be speaking on how to respond to this challenge in the Balkans in particular.

As we know, in the Balkans, despite the passage of nearly two decades since the end of armed conflict, democratic transitions remain woefully incomplete. Against that backdrop, in recent years, external actors have reasserted their role, diverting the Balkans from a trajectory of Euro-Atlantic integration. As the panelists will explain, corrosive capital has emerged as a key element of that approach, posing a major challenge for governments, business communities, and civil society across the region.

In response, in 2017, CIPE embarked on a unique project, pioneering a new, comprehensive methodology to analyze:

- first, how what we call "governance gaps"—such as loopholes in anticorruption policies, non-transparent procurement practices, and a lack of strong competition policies—create in the Balkans opportunities for the inflow of corrosive capital; and
- second, how that capital widens those governance gaps and potentially undermines the consolidation of democracy in the region.

A network CIPE partners, represented by the panelists today—from Bulgaria, Montenegro, Serbia, Macedonia, and Bosnia and Herzegovina—have identified specific governance gaps, and in particular, have examined the extent and impact of Russia's economic footprint in the region.

We recognize that in recent years, the countries of the Balkans have made important progress, but as the panelists will discuss, judicial and executive institutions are still not sufficiently independent, efficient, or accountable; implementation and enforcement of legislation is often weak and inconsistent; and further efforts are needed to tackle corruption, and to make public budgeting, procurement and privatization more transparent.

We are honored that the Helsinki Commission has invited CIPE's partners here to inform a U.S. audience about these issues, just as they are raising public awareness in their own countries. In addition, working with local business and civil society leaders, they are seeking to create greater transparency about foreign investment in the Balkans, and to advocate with policymakers to close identified governance gaps. By so doing, they aim to ensure that local business can compete on an equal footing, and that all investors enjoy a level playing field.

This, in turn, will make markets and democracies in the Balkans more resilient to potential untoward external influence, and help ensure inclusive economic growth. This effort can contribute to democratizing economic opportunity in the Balkans, and countering the worrying spread of a perception in the region that democracy and markets have failed average citizens. We note that the European Commission plans to adopt a new strategy to boost democratic transition and economic reforms in the region.

By tackling the challenge of corrosive capital in the Balkans, CIPE is also developing tools and approaches that can benefit other emerging democracies worldwide, including across Asia, Latin America, and Africa. We look forward to future opportunities to share the results of that work with you as well.

Finally, I would like to close by thanking the National Endowment for Democracy for its support of the CIPE program that engages with today's panelists. Of course, such projects are, in turn, made possible thanks to the critical commitment of the U.S. Congress to funding the NED. Thank you.

Prepared Statement of Ruslan Stefanov, Director, Economic Program, Center for the Study of Democracy

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

January 30, 2018

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 strengthen 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, particularly 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.

Prepared Statement of Milica Kovačević, President, Montenegrin Center for Democratic Transition

Assessing the Risks of the Russian Economic Footprint in the Western Balkans: Governance Vulnerabilities and Russian Footprint in Montenegro

January 30, 2018

Chairman Wicker and Co-Chairman Smith, Distinguished Members of the Committee, Senate and the House of Representatives,

Thank you very much for having us here, to share our thoughts on the challenges facing the Western Balkans.

During the Cold War, in 1956, Yugoslav Ambassador to Moscow, Montenegrin Veljko Micunovic, wrote to Yugoslav President Tito that history of our economic relations with Russia is not less dramatic than history of our political relations. “For Russia, today, as in the past, every trade is a direct mean of politics,” he wrote. Even today, it has continued to remain valid. The playbook for our region has always been the same.

In the last decade, we saw a significant level of economic engagement by Russian companies and individuals in Montenegro. In addition to their economic relationship, Montenegro and Russia had sparkling political ties.

Political relations have however deteriorated since 2013, as Montenegro moved forward with its NATO integration. So far, this change in the relationship has not yet significantly affected the economic ties between the two countries, but there have been some warnings coming from Russian officials. Russian Foreign Minister, Sergey Lavrov, stated in March 2017 that Montenegro sacrificed its economic relations with Russia by joining NATO. The dependence of Montenegrin economy on Russian investment in real estate and Russian tourism raises the possibility that further deterioration in bilateral relations could pose a grave risk to our economy.

Today, Russian foreign direct investment (FDI) in Montenegro makes up close to a third of the country’s gross domestic product (GDP). Russia is the single largest direct investor in Montenegro, with USD 1.27 billion in cumulative investments—equal to 13 percent of all FDI stock in the country. The majority of the FDI is concentrated particularly in real estate and tourism.

The number of Russian tourists in Montenegro has consistently increased in the last ten years. Russian tourists make around one quarter of the total number of country’s visitors. This is very important because tourism is the key sector of Montenegro’s economy and the most powerful generator of economic growth. It makes up around one-fifth of the Montenegrin GDP and over 54 percent of all exports.

It is however true that Russia’s share of the overall Montenegrin economy significantly shrank in recent years, from 29.4 percent of total revenue in 2006 to around 5.5 percent in 2015. This is largely a result of the withdrawal of the Russian capital from the Podgorica Aluminum Plant (KAP), one of the largest companies in the country.

A similar trend can be observed in an analysis of the number of employees working for Russian-controlled entities in Montenegro, which fell from 14.2 percent in 2007 to just 2.3 percent in 2015. Again, primarily because of the loss of control of KAP.

Based also on the experience of some other countries in the region where some of the initial Russian investment in energy for example spilled over to a number of other economic sectors, we can now only contemplate what would have happened if the Parliament have not stopped the acquisition of country's key energy resources by KAP's owner Oleg Deripaska in 2007.

The Government of Montenegro rejected a Russian request to use the Montenegrin port of Bar for military purposes, despite the fact that Russia had allegedly proposed payments worth at least half of the Montenegrin GDP. In 2014, Montenegro also aligned with the EU sanctions following the annexation of Crimea.

Prior to NATO admission, the Russian government condemned Montenegro's membership aspirations and actively worked to prevent it, in particular by backing ethnonationalist groups whose policy platforms are at odds with Western values. Russian Deputy Prime Minister Dmitry Rogozin went even further when he said that Montenegro would regret joining NATO. In parallel, the Russian media started to run a negative campaign to prevent Russian tourists from coming to Montenegro describing it as a dangerous place.

Montenegro accused the Russian Federation of meddling in the 2016 parliamentary elections by attempting to overthrow the government through the strongest opposition coalition in Montenegro—the Democratic Front (DF). There is an ongoing court case for the coup attempt against some of the DF leaders for acting against the country's constitutional order. The indictment also includes two Russian military intelligence officers and several Serbian nationalists. Furthermore, another DF leader is being charged with participation in a money-laundering scheme during the 2016 election campaign. Allegedly, the DF used funds of criminal origin, provided in large amounts by Russia through offshore accounts, and then split into small installations and sent to individuals, who then donated the money to the party.

Nevertheless, Montenegro managed to resist the allegedly Russian-orchestrated use of hard power as well as soft power, joining NATO in 2017. Yet, even NATO admission has not completely brought Montenegro out of the danger zone. Russian interest in the Western Balkans has never been to annex the region, but to keep it unstable and as far from the Western integration as possible. Many analysts agree that the region's integration in the EU will be the next target.

EU integration is supported by the overwhelming majority of citizens and key political actors in Montenegro. The report that we prepared examines the governance gaps that have been exploited for the intrusion of the corrosive capital, and offers recommendations on how to close these gaps to prevent further deterioration. Addressing these gaps is essential for our democratic reforms, inclusive economic growth, and EU integration. In order to succeed, we remain determined to advancing the progress made so far and would welcome even more international support.

Mr. Chairman,

I would like to thank you for your ongoing support and commitment to the region. The West should be persistent in demanding real democratic progress in our countries because it is the key to security, stability, prosperity, and resilience to harmful foreign influence both in the region and beyond its borders. Civil society in the Western Balkans looks with hope at the United States' enhanced diplomatic engagement and relies on your help in ensuring that the region remains on its Euroatlantic integration path.

Prepared Statement of Nemanja Štiplija, Founder, "European Western Balkans" media outlet [1]

January 30, 2018

Dear Mr. Hand, Dear Guests,

Thank you for the opportunity to appear before the Commission today. Allow me to thank also the Center for International Private Enterprise and the National Endowment for Democracy for their support and the opportunity to present our views here in Washington. We very much appreciate the interest of the Helsinki Commission in issues that are of great importance for the stability and future prosperity of the Balkans.

Serbia is one of the key countries where Russian influence is most obvious. Since 2008, it has been based on two pillars. First is the issue of Kosovo (Russia is perceived as the main supporter of Serbia in the international arena). Second is the Russian engagement in Serbia's energy sector, which dates back to the South Stream construction deal and the (below price) purchase of the oil industry of Serbia (NIS).

Furthermore, following particularly the global economic downturn and 2014 Ukraine crisis, the Russian influence has spilled over to the other key economic sectors, such as the financial sector and infrastructure (railways). The economic engagement, high-level political visits, and strengthened cultural and religious ties mutually reinforce each other.

While most research has focused on the outright political influence, it often disregards the sophisticated networks in nations economies that exploit and exacerbate the democratic deficits in Serbia and throughout the Western Balkans.

Despite the fact that the South Stream was discarded, Russia still dominates Serbia's oil and gas sector. Through NIS, Russia almost completely runs oil production, refining, and retail. Next, Serbia imports more than 70 percent of its crude oil consumption and close to 65 percent of its natural gas needs from Russia. What's more, Russia is the only importer of gas to Serbia and it favors inflexible long-term deals. Through those deals, it has gained control over a state-owned wholesale gas supplier, Srbijagas, which has, as a result, accumulated debt effecting Serbia's financial health. Srbijagas, the state-controlled Serbian company, holds a dominant position on the national gas market. An intermediary (Yugorosgas), which is owned by Gazprom, receives around a 4 percent premium on the gas it resells to Srbijagas. Besides Srbijagas, Russians generally do a lot of business with state-owned companies and those with close connections to politics. That is why the country needs to advance the reform of its public administration as soon as possible. Gas diversification is long-overdue. Furthermore, steps are needed to tackle the restructuring and privatization of Serbia's enterprises. Based on our analysis, lowering the budget deficit and reducing the high public debt level, including debt generated by companies of strategic importance also remain a challenge.

With regard to the private sector, Russians fully or partially own approximately 1,000 companies in Serbia. They control revenues of close to EUR 5 billion, or 13 percent of the total revenue generated by the country's economy. Russian companies are also amongst the major employers in the country, directly employing approximately two percent of the

[1] These findings are part of the project implemented by the Center for Study of Democracy, Sofia, Bulgaria, and a group of Balkan experts. The findings and opinions expressed are those of the CSD and experts and do not necessarily reflect the views of experts' employers.

total labor force and indirectly employing around 5 percent. What is important is that such employment is concentrated in just a few industrial enterprises.

Export to Russia have become an important aspect of the economic relationships between Russia and Serbia, particularly following the expansion of the free trade agreement (in 2009 and 2011). Russia's 2014 embargo on the imports of EU agricultural and food products has provided a boost to exports in non-EU countries in the Western Balkans. Nowadays, Serbia's export to Russia is the highest by volume in the Southeastern European region after Greece.

Russian foreign direct investment (FDI) remained relatively small, amounting to 4 percent of all FDI stocks in Serbia according to date available for the period from 2005 to 2016. Should we account also for investment flowing from third states but still attributable to Russians along with their reinvestment from profit the total Russian FD) would be around USD 2 billion, or 6 percent of the country's GDP.

During Serbia's fiscal crisis, Russia further deepened its engagement with the Serbian economy by adding loans to the array of other tools deployed to promote its interests. Some of these loans reportedly stipulated less favorable conditions than those of the international economic institutions and even granted preferential status to Russian state owned contractors for the infrastructure modernization projects While Russia's presence in the finance sector is somewhat limited (through three banks that occupy a small portion of the market), borrowing loans from Russian banks may involve risks as shown by recent Agrokor crisis. Relying heavily on bank loans, this retail has recently expanded into almost all countries of the Western Balkan, including Serbia. In early 2017, not only Agrokor employed some 60,000 people throughout the region but also accumulated debt totaling around USD 6.4 billion or six times its equity. Sberbank owns around 18 percent of it. Despite the debt, Agrokor remained relatively stable until a statement of Russian Ambassador to Croatia sent shockwaves through the market. Again, in Russia's mind, the economic engagement and other tools mutually reinforce each other. Russia attempts to wield influence also through initiatives in the spheres of media, culture, church, nonprofits, and academia. It provides support, including financial, to organizations, groups, and individuals that promote Russian interests in foreign countries, including in Serbia. In Serbia, Russia has supported development of several media enterprises and information initiatives of major Russian media outlets. For example, the state-owned news agency Sputnik opened its regional editorial office in Belgrade in 2015. They seek to disorient the local audience by offering narratives that exploit Serbia's weak spots in and promote the Russian interests.

To conclude, I would like to stress that all relevant actors, whether Serbian, regional or international, need to recognize the potential costs of the inflow of corrosive capital the region is facing. They should press for real democratic progress, which is the real key to regional security, long-term stability, inclusive growth, and countering malign foreign influence. Based on the analysis I conducted together with a Research Director of ISAC Fund Igor Novakovic and in addition to the regional report presented by the Center for Study of Democracywe would like to make the following country-specific recommendations:

Serbia should ensure that infrastructure projects funded by foreign governments are not exempt from the EU's and national laws on public procurement and transparency and are in accordance with relevant international rules. Hence, Serbia's energy infrastructure projects should follow the country's obligations on the European level, including in the areas of ownership of gas transmission, supply, and production.

Serbia should explore it's the possibility of completing its natural gas interconnections with Bulgaria and Croatia to allow for diversification of the gas supply.

Commission for Protection of Competition should prevent the concentration of ownership in strategic sectors such as the oil and gas sector and monitor possible market collusion that hinder competition and lead to monopoly.

There needs to be a clear separation of the management of state-owned energy companies and politics. Government's nominations of professional management should be considered by the parliament to ensure its independence from external pressure.

Serbia should ensure that the sale of distressed companies and assets is transparent and should be careful about potential concentration of capital in the hands of a small number of politically-connected businesses.

Media and communications regulators, the Republic Broadcasting Agency and the Republic Telecommunications Agency, should investigate ultimate beneficial ownership of media and alert counterintelligence in cases of foreign covert operations involving disinformation campaigns in the country.

Finally, the media should play a critical role in objectively informing (even educating) the public about how strategic economic sectors, such as energy, function to debunk existing misconceptions and expose those decisions that harm Serbia's public interest. In this respect, the government should ensure that media outlets operate in a safe environment and are granted full access to public data and information.

CENTER FOR
THE STUDY OF
DEMOCRACY

ASSESSING RUSSIA'S ECONOMIC FOOTPRINT IN MACEDONIA

Policy Brief No. 71, January 2018

Overview

Russia's economic footprint in Macedonia can be described as non-existent at best or very limited at worst. However, a detailed assessment of Russia's economic presence in the country reveals a more nuanced picture, in which many channels of engagement are indirect, including through third parties and offshore companies. Former Prime Minister Nikola Gruevski and his coalition were instrumental in strengthening Macedonian ties with Russia through an expanded engagement in not only the national, but also regional energy sectors. Fully dependent on Russian gas and possibly with the aim of becoming a natural gas transit center, Gruevski sought to enter two large-scale Russian-led gas pipeline projects: South Stream and its replacement, Turkish Stream. Following opposition from European regulators, and in part due to declining gas consumption in Central and Eastern Europe, Gazprom canceled South Stream and announced Turkish Stream, a project which could secure a market for more gas coming from multiple gas development projects in Western Siberia and the Yamal Peninsula in Russia.

Outside the oil and gas sector, trade between Russia and Macedonia has historically been small. Bilateral trade recently saw some uptick due to in-

KEY POINTS

- The Russian economic presence in Macedonia has been growing over the past decade albeit from a minimal starting point.
- The revenues of Russian companies operating in Macedonia grew fourfold from EUR 63 million in 2006 to over EUR 212 million in 2015. Still, they make up a little over 1 % of the total revenues in the economy.
- Much of Russia's investment in Macedonia is channeled via third countries including through offshore havens like Cyprus and Belize, obscuring the true extent of the economic footprint.
- Russia has engendered Macedonian energy dependence by controlling the single gas route to the country – via the TransBalkan Pipeline. Gazprom charges Macedonia one of the highest gas prices in Europe, and has locked in the country in a costly expansion of the natural gas network.
- Though the Russian economic footprint in Macedonia has been much less pronounced than in other Western Balkan countries, there is significant potential for future growth considering Russia's project plans in the energy sector over the next decade.
- Over the last two years, Russia has skillfully exploited Macedonia's political instability, striving to undermine the country's Trans-Atlantic ties.

This report was compiled using publicly available sources and databases. CSD would like to thank Emina Nuredinoska, Head of Civil Society Department, Macedonian Center for International Cooperation, and Slagjana Dimiškova, Investigative journalist who contributed to the analysis, as well as Dr. Dimitar Bechev, Research Fellow, Center for Slavic, Eurasian, and East European Studies, University of North Carolina at Chapel Hill and Ilya Zaslavsky, Research Expert, Free Russia Foundation and Academy Associate at Chatham House, for providing valuable comments.

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creased Macedonian agricultural exports following a 2014 Russian decision to embargo EU-produced agricultural goods, which opened space for otherwise non-competitive producers, such as those from Macedonia. Macedonia was allowed by Russia to export more after its refusal to join the EU and U.S. sanctions against Russia over its annexation of Crimea. Although Macedonia currently maintains a trade deficit, it fell from around 5 % of gross domestic product (GDP) in 2006 to about 0.5 % in 2016. This was mainly due to the fall in natural gas prices and Macedonia's diversification away from imported Russian crude oil. In absolute figures, the trade turnover between the two countries has never been more than EUR 400 million per year, and is currently around EUR 100 million.

Similarly, Russian direct investments in the country are just EUR 27 million (in 2015), compared to, for example, Austrian investment in Macedonia of over EUR 500 million. Russian direct investments in the country began around 2009 but have increased incrementally since then. Russian businesses have also invested indirectly through offshore accounts held in countries such as Cyprus, Belize, or others with preferential tax regimes such as the Netherlands, where Lukoil, the largest Russian company operating in Macedonia, is registered, as becomes clear when reviewing corporate footprint data to identify offshore companies with their ultimate beneficial owners located in Russia. One example is the sports and gambling business of Russian businessman Sergei Samsonenko, who is one of the wealthiest individuals in Macedonia. As detailed in this report below, he built strong ties with the former government of Gruevski and his circle, including powerful Macedonian businessmen such as the co-owner of the Iskra MM company, Cvetan Pandeleski, and Orce Kamcev,[1] purportedly the richest person in Macedonia. Samsonenko also supported Gruevski's election campaign in 2014.

Over the last two years, there has been increasing evidence of Russian efforts to take advantage of Macedonia's political instability and undermined the country's Trans-Atlantic aspirations. In 2017, confidential information was leaked that appeared to indidcate that that Russian agents operated in Macedonia with the aim of blocking the country's entry into NATO.[2] There are indications that Russia sought to use the Macedonian energy sector to dominate the country's politics. Such a strategy was employed in Bulgaria and Serbia, and is consistent with strategies identified in *The Kremlin Playbook* regarding Russia's use of vulnerable economic sectors and weakly governed state-controlled businesses to establish with a range of countries long-term, asymmetrical relationships.[3] On the political level, Russian Foreign Minister Sergei Lavrov publicly blamed the West for creating the crisis in Macedonia to support allied politicians.

In sum, though the Russian economic footprint in Macedonia is less significant than in other Western Balkan countries, there is significant potential for future growth considering Russia's projected plans in the energy sector over the next decade.

Russia's Economic Footprint in Macedonia

Russia's economic presence has been growing steadily over the past decade, from a low starting point. A detailed analysis of Russia's corporate footprint shows a total of 78 companies registered in Macedonia with at least 25 % of their shares owned by Russian entities or individuals. The revenues of Russian companies operating in Macedonia grew fourfold from EUR 63 million in 2006 to over EUR 212 million in 2015.[4] Still, these companies make up a little over 1 % of the total revenues in the economy, with close to half of the revenue generated by one company:

[1] Rajcheska, Angela and Stankovich, Bianka (2016). Samsonenko: Successful in Macedonia-under scrutiny in Russia. Center for Investigative Journalism (SCOOP), 5 December, 2016.

[2] OCCRP (2017). "Leaked Documents Show Russian, Serbian Attempts to Meddle in Macedonia," 4 June, 2017.

[3] Conley, A. Heather, Stefanov, Ruslan, Mina, James and Vladimirov, Martin (2016). Kremlin Playbook: Understanding Russian Influence in Central and Eastern Europe. CSIS/Rowman & Littlefield, October, 2016.

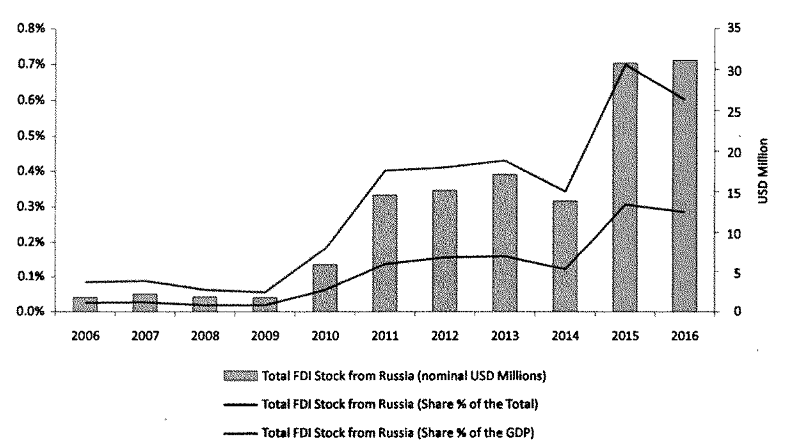
[4] CSD calculations based on data from Eurostat, and corporate registers and databases.

Lukoil, a retail fuel distributor. The other half is concentrated in the two largest gas pipeline construction companies that arecurrently expanding Macedonia's domestic gas transmission and distribution network, and the aforementioned Samsonenko's gambling business.

In comparison, Macedonian companies with Austrian and Dutch beneficial ownership directly control more than 26 % of the total revenues of all businesses in the country and 24 % of the total assets in the economy, as well as employing 15 % of the labor force.[5] Greek companies make up another 13 % of the economy; Hellenic Petroleum, operator of the OKTA refinery, is the largest Greek investor. Some of the largest companies in Macedonia are also from the above-mentioned countries, including a power distribution provider, EVN, as well as a Kavadarci ferro-nickel plant owned by the largest nickel producer in Europe, Cunico Resources, currently registered in the Netherlands. With a significant stake in the banking, fuel distribution, and shipping sectors, Greece arguably has the largest corporate presence in the country[6] and in one case, there are indications that Russia may have tried to use a Greek firm to expand the Russian footprint in Macedonia.

Some of the Russian corporate footprint in Macedonia is currently channeled through third countries. One example is the Russian mining company Solway, which operates a lead, zinc, and copper mine in Macedonia, but is officially registered in Switzerland. Another is a large Russian power plant operator, TKG, which owns a joint-venture, the TE-TO Combined Cycle Heat and Power Plant near Skopje, through a Cypriot offshore intermediary.[7] To consider the mines

Figure 1. Stock of Russian Foreign Direct Investment



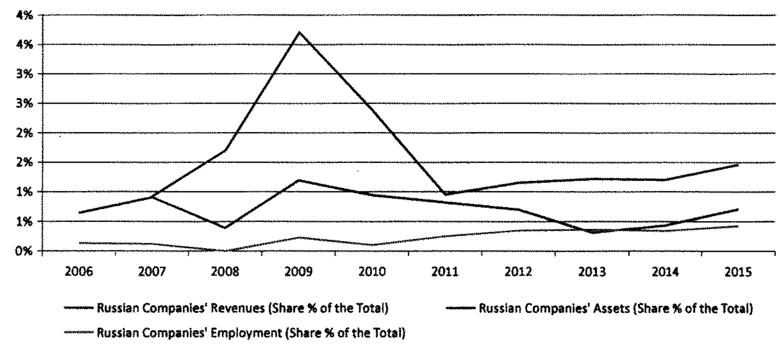
Source: CSD calculations based on Macedonia's Central Bank and UNCTAD statistics.

[5] Ibid.

[6] Ibid.

[7] Фомичева Анастасия (2015). "Sorry, Skopje: TGK-2 lost the right to a 100 % ownership of the TPP in Macedonia," Komersant, 14.10.2015, https://www.kommersant.ru/doc/2832233

Figure 2. Russia's Corporate Footprint in Macedonia



Source: *CSD calculations based on a commercial corporate database survey using ultimate beneficial ownership as criteria.*

operated by Solway and TE-TO as Russian-owned companies in this assessment would nearly double the extent of the Russian economic footprint in Macedonia.

Macedonia currently imports mostly natural gas and oil derivatives from Russia. Hence, with the fall of oil prices on world markets after 2014, the country's import costs have significantly shrunk. Imports from Russia fell from around EUR 300 million per year from the 2006 – 2011 period to EUR 58.3 million in 2016, of which EUR 55 million were mineral fuel products. Conversely, Macedonian exports to Russia have more than doubled in the past decade, reaching around EUR 50 million in 2016, or 2.4 % of Macedonian total exports. Until 2016, Macedonian exports were dominated by pharmaceuticals produced by a Macedonian subsidiary of a Russian pharmaceutical giant, Protek, and agricultural products (mostly fruits and vegetables). These agricultural products have become more attractive and competitive on the Russian market following Russia's embargo on EU agricultural exports in response to 2014 sanctions against Russia.[8] Macedonia and Russia worked on including dairy and meat products in the country's export portfolio, but Russia's high import tariffs and strict food regulations prevented a major expansion of this trade. At least since 2014, the Macedonian government of former Prime Minister Gruevski floated the idea for a free trade agreement between the two countries, but this did not materialize.

Russian foreign direct investment (FDI) in Macedonia has increased since 2014 following the establishment of closer ties with the government of former Prime Minister Gruevski. Still, Russian FDI in the country was estimated at just around EUR 31 million in 2015, or less than 1 percent of the total FDI in Macedonia.[9] For comparison, in 2015, Dutch FDI in Macedonia accounted for a quarter of the total, or around USD 1.05 billion, while Austrian investments were close to 12 percent.[10] Austria and the Netherlands are the two the largest investors in Macedonia, and more generally, in the region. The biggest direct

[8] Currently, the biggest pharmaceutical exporter to Russia is the Alkaloid company. Protek closed its plant in 2016.

[9] CSD calculations on the basis of foreign direct investment statistics from the Macedonian Central Bank, UNCTAD and the Russian Central Bank.

[10] Ibid.

Russian investment in the country is through the pharmaceutical company Protek, owned by Russian businessman Vadim Yakunin. The company has invested around EUR 13 million since 2011.[11]

However, according to our findings, Russian indirect investment appears to dwarf its FDI in Macedonia. The two largest Russian investments in the country date back to 2005 when Lukoil and Itera invested in a chain of gasoline stations and a combined heat and power plant, respectively.[12] Both investments were channeled through third countries, including Cyprus and the Netherlands. In the period from 2005 to 2016, Lukoil invested USD 50 million in Macedonia.[13] If we include third-party investments channeled through Switzerland, Belize, and Cyprus by Solway, Sintez, and Samsonenko's BetCity, Russian investment in the country would be at least six to seven times larger, amounting to USD 200 million in FDI stock, or around 4 % of all FDI. Notably, in 2015, the biggest investor in Macedonia was Bermuda (USD 200.7 million).

Vulnerable Sectors

Energy

Macedonia is a country with exceptionally high dependence on fossil fuels: over 80 % of the primary energy in the country comes from coal and oil. Depending on the year, Macedonia imports up to half of its energy needs. Meanwhile, the energy sector has suffered from very high levels of energy intensity, which is estimated to be 40 % higher than the EU average.[14] Energy inefficiency has pushed up the country's energy import costs and has significantly strained the economy. This energy dependence is exacerbated by the fact that Russia controls the single gas route to Macedonia. The Macedonian gas market is fully dependent on imports from Gazprom via the TransBalkan Pipeline, which passes through Ukraine, Romania, and Bulgaria. Gazprom charges Macedonia one of the highest gas prices in Europe.[15] The high gas price and the inflexible take-or-pay contract terms with Gazprom have placed financial strain on some of the major gas consumers in Macedonia.[16]

In the oil sector, Macedonia's OKTA refinery no longer depends on Russian crude oil, as it ships from a Thessaloniki port controlled by Hellenic Petroleum, a major fuel producer and supplier in the country. In 2016, Rosneft attempted to purchase the Greek state-owned company, though no agreement was reached. Considering that OKTA is the sole refinery in Macedonia, the potential Russian purchase of Hellenic Petroleum would have increased Russian control of the oil sector in Macedonia had the purchase gone through. This incident underscores that Macedonia's reliance on one pipeline and one refinery potentially poses economic and political risks to the country.

Natural Gas

Macedonia does not have a well-developed gasification network, and natural gas is not a major part of the country's energy supply. In 2016, Gazprom delivered only 70 mcm of gas, the lowest in Europe.[17] Macedonia's remarkably low gas consumption spared the country the impact of 2006 and 2009 gas supply cuts caused by Gazprom's debt disputes with Ukraine. Macedonia had little difficulty in switching to heavy fuel to substitute for the gas supply cut.

[11] CSD calculations based on multiple media reports.

[12] "Lukoil Plans to Increase the Investment in Macedonia." Lukoil Press Center. 21 June, 2012.

[13] Stefanova, Natasha (2016). "Lukoil Plans to Increase the Investment in Macedonia." SITEL, 30 September, 2016, accessed on January 13, 2018 at http://sitel.com.mk/lukoil-najavuva-novi-investicii-vo-makedonija

[14] Stojkovska, Iskra (2012). Energy Policy in Macedonia in the Context of the EU Integration, Front 23/42, April 2012.

[15] Gazprom's Grip: Russia's Leverage Over Europe. RadioFreeEurope – Infographics on the Russian gas dependence in Europe by country, accessed on 9 November, 2017 at https://www.rferl.org/a/gazprom-russia-gas-leverage-europe/25441983.html

[16] A take-or-pay clause stipulates that a buyer is obliged to either take up all of the contracted gas volumes or pay a certain percentage of them.

[17] Gazprom statistics on gas supply to Europe accessed at Gazprom's official website: http://www.gazpromexport.ru/en/statistics/, accessed on 30 November, 2017.

Heat production is based predominantly on the use of coal, wood, and fuel oil. The country generates roughly 80 % of its electricity through two lignite-fired power plants in Bitola and Oslomej, both owned by a state-owned power monopoly, ELEM, with a combined capacity of 800 MW. The remaining 20 % is provided by hydroelectric power plants (528 MW – also owned by ELEM and several private companies) and marginal volumes of wind and solar power. Macedonia is also among the biggest lignite producers and holds around 2.5 billion Mt of reserves. Hence, the country is planning to construct additional lignite-based power stations despite its obligations to Brussels to invest in renewables instead. Macedonia has not been able to implement many of its obligations, including unbundling of ELEM and the liberalization of the power and gas markets, which are still highly regulated and non-transparent.[18] Poor management and a highly regulated below-cost power and gas price environment have led to an accumulation of large debts on the part of these state-owned companies. As a consequence, the companies have neglected much-needed infrastructure improvements, which further imperils the security of the supply chain. Macedonia's energy security risks are also associated with widespread energy poverty among households, which find it difficult to pay their electricity bills and are widely reliant on burning low-quality wood and lignite for heating. This contributes to high levels of air pollution and associated health risks.

The government sees household gasification as one possible solution to the country's energy poverty. However, there has been limited infrastructure development in Macedonia. The underdeveloped domestic gas network, supplied by the TransBalkan pipeline, reaches only Strumica in Eastern Macedonia and the outskirts of Skopje, where it connects to several industrial clients and the TE-TO Skopje Combined Cycle Heat and Power (CCHP) plant. Consecutive governments have continued to support natural gas network expansion in the country and engaged with the Gazprom-led South Stream and Turkish Stream pipelines. In July 2013, the Macedonian government signed a bilateral agreement with Russia to construct an offshoot of South Stream, although there was great uncertainty regarding how exactly to link Macedonia to the pipeline.[19] After abandoning the project following a dispute with regulators in Brussels,[20] Russian President Vladimir Putin announced a new project, Turkish Stream, which would consist of two pipelines to Turkey, each delivering a little less than 16 bcm of gas per year. The first line would supply only the Turkish domestic market, while the second would transport gas either through Greece or Bulgaria to Macedonia, Serbia, and Hungary along a new pipeline, TESLA, and would terminate at the Baumgarten gas hub near Vienna. These plans are similar to the initial South Stream project plans, but only TESLA has been included in the European Commission's Projects of Common Interest (PCI). PCI inclusion is a pre-condition for possible EU financing.[21] The pipeline is scheduled for 2019, which appears unrealistic, considering the slow progress of Turkish Stream and opposition in the EU to a new Russian pipeline from the South. The inclusion of TESLA in the list of EU Projects of Common Interest (PCI) in 2015 seems to be the result of heavy lobbying on the part of Hungary, which has been the diplomatic leader in pushing TESLA through.[22]

The former Macedonian government embraced TESLA and worked closely with a Russian gas construction company, Stroytransgaz, to extend the domestic natural gas pipeline network. Stroytransgaz is owned

[18] European Energy Community (2017). Annual Implementation Report. 1 September, 2017, Energy Community Secretariat.

[19] B92 (2013). "Russia and Macedonia sign South Stream offshoot deal," 24.07.2013, accessed on 16 November at http://www.b92.net/eng/news/region.php?yyyy=2013&mm=07&dd=24&nav_id=87050

[20] RFERL (2014). "Bulgaria Suspends Work On South Stream Pipeline". Radio Free Europe, 8 June, 2014, accessed on 21 November, 2017 at https://www.rferl.org/a/bulgaria-suspends-work-on-south-stream-pipeline/25414739.html

[21] Georgiev, Georgi (2015). "CE/SEE partners eye EU funds for Tesla gas pipeline project," SeeNews, 28 August, 2015 accessed on 21 November at: https://seenews.com/news/cesee-partners-eye-eu-funds-for-tesla-gas-pipeline-project-490558#sthash.zOUb2R0v.dpuf

[22] Ibid.

by the U.S.- and EU-sanctioned Gennady Timchenko. The same company was reportedly responsible for constructing an offshoot of the South Stream pipeline before the project's cancellation.[23] The cancelled project was planned at USD 200-300 million and would have been partially financed by the Russian state as a way to repay USD 60 million in Soviet-era debt to Macedonia. Russia's Finance Ministry announced in February 2017 that it would clear the debt to Macedonia by the end of the year.[24] In effect, in repaying this longstanding gas debt to Macedonia through financing the expansion of the domestic pipeline infrastructure, Russia would have financed a company with strong ties to Kremlin, which had previously received billions of U.S. dollars through other pipeline projects in Russia and Europe.

Despite the failure of South Stream and the somewhat unclear fate of TESLA, the government has partially followed through with the plans to expand its network. In August 2016, Stroytransgaz completed the construction of the 96 km, USD 75 million Klecovce – Negotino pipeline, linking Macedonia with the Serbian gas system.[25] The company also planned to complete a link to Greece, where it would potentially connect to the second line of the Turkish Stream pipeline at the border.

In October 2016, Macedonia's and Greece's transmission operators, MER and DESFA, signed an agreement to connect their networks via a 160 km interconnector between Stip, where the extension of the Russian-built Klekovce-Negotino pipeline ends. This new pipeline is a welcome move in the process of gas diversification that could possibly link the Macedonian gas system with Azeri gas flowing through the Trans-Adriatic Pipeline (TAP).[26] Unfortunately, consecutive Macedonian governments have balked at this opportunity to diversify gas supply. Instead, government officials have decided to pursue economically unrealistic, contractually rigid, Gazprom-managed pipeline projects: South Stream, Turkish Stream, and TESLA. The decision to begin large-scale gasification exclusively with a company close to the Kremlin (Stroytransgaz) and Gazprom in order to recoup its Soviet-era debt is one example of a region-wide pattern of Balkan governments acting against what would appear to be in their national interests.

Similar approaches can be observed in Bulgaria and Serbia. Consecutive governments in Bulgaria have not been willing to complete a number of strategic energy security projects, such as the gas interconnectors with Greece, Romania, Turkey, and Serbia, and instead have focused almost entirely on building a Gazprom-led large-scale pipeline through the country, either South Stream or Turkish Stream. In Serbia, the government agreed in 2008 to sell its largest company, Naftna industrija Srbije (NIS), to Gazprom at a below-market price without improving the terms of its long-term gas contract. This precipitated huge losses for the state-owned gas supplier, Srbijagas, and the Serbian budget.

Throughout the region, there is one key popular economic misconception associated with the South Stream project: that hosting a large Russian gas pipeline would transform local economies, create thousands of jobs, and generate new businesses, and that the construction of the pipeline would benefit Balkan countries through cheaper natural gas, which would, in turn, facilitate expanded gas transmission. It appears that this view is not grounded in facts or detailed economic impact assessments, but have drawn on statements of high-level politicians and business leaders.[27] The idea that a Russian pipeline

[23] Luhn, Alec (2014). "Gennady Timchenko denies Putin links made him one of Russia's top oligarchs," 24.03.2014, accessed on 16 November at https://www.theguardian.com/world/2014/mar/21/oligarch-timchenko-denies-putin-links-us-blacklist-sanctions

[24] RT (2017). "Russia to clear entire Soviet debt by year-end", RT, 17.02.2017 accessed on 10 November at https://www.rt.com/business/377676-russia-pays-soviet-debt/

[25] "Macedonia completes part of its gas network", economynews.bg, 01.08.2016.

[26] Balkan Energy (2016). "MER and DESFA signed MoU on gas pipeline construction", 14 October 2016 accessed on 10 November at http://balkanenergy.com/mer-and-desfa-signed-mou-on-gas-pipeline-construction-region-14-october-2016/

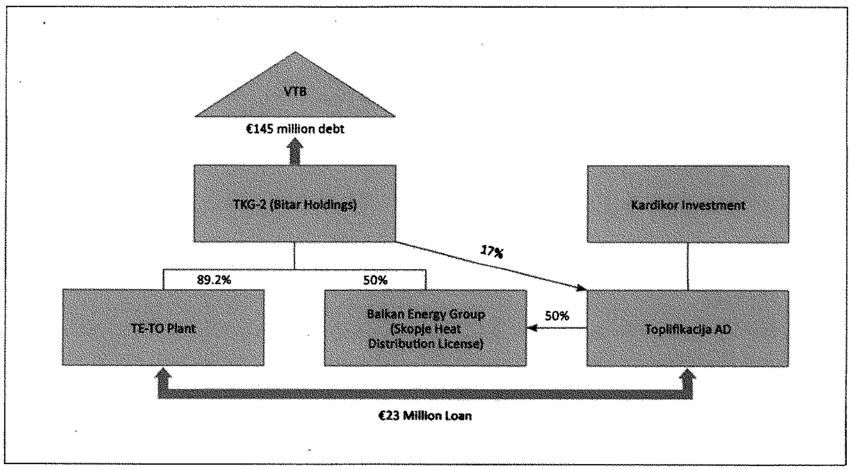
[27] Marusic, Sinisa (2013). "South Stream Deal Boosts Macedonia's Gas Prospects", BalkanInsight, 26 July, 2013.

project would bring more energy security to the host countries can be contrasted with the experience of Ukraine and Belarus, which have both faced continued supply disruptions, despite serving as the main transit countries for Russian gas.

From 2006 to 2013, the promise of closer cooperation between Macedonia and Russia on natural gas pipeline projects spilled over into a number of related joint projects, including the biggest individual Russian investment in the country: the construction of a 220-MW gas-fired heat and power plant near Skopje, the above-mentioned TE-TO plant. CCHP is owned by Russia's TKG-2 company, a subsidiary of the Sintez Group, owned by Russian Senator and businessman Leonid Lebedev. TKG-2, which controls 80 % of the shares (through the Cyprus-based offshore company Bitar Holdings), completed CCHP in 2010 for EUR 136 million (see Fig. 3 for a visualization of ownership links). At the time, there was a widespread belief in Macedonia that Gazprom had control of the Sintez Group.[28] In 2013, Sintez further increased its stake at TE-TO to 89.2 %.

Sintez purchased another 9 % from Toplifikacija, a private heat distribution company, which until 2012 had a monopoly over the heating supply in Skopje.[29] In 2012, an offshore-registered company, Balkan Energy Group, also controlled by the owners of the TE-TO plants, received a license to take over heat production, distribution and supply to the city, despite the fact that there was no information about the financial or managerial capacity of the firm.[30] Hence, in the past five years, one Russian company has indirectly taken over heat production and distribution in Skopje. This close interdependence cre-

Figure 3. TE-TO CCHP Plant Ownership Structure



Source: *CSD.*

[28] Earlier, TE-TO was owned by the Russian companies Itera (60 %) and Bitar (20 %).

[29] Toplifikacija's major shareholder is a mysterious Cyprus-based company Kardikor Investment. MKD (2012). "Балкан Енерџи Груп" ќе произведува, дистрибуира и снабдува топлинска енергија за Скопје", 30 December, 2012, accessed on 16 November at https://www.mkd.mk/86917/ekonomija/balkan-enerdzi-grup-ke-go-snabduva-skopje-so-parno-greenje

[30] Immediately after taking over the heating licenses, Balkan Energy Group began accumulating debt to Toplifikacija as described by the annual reports of the company from 2013 to 2015.

ates a potential vulnerability for the Macedonian energy sector.

By 2013, TE-TO accumulated around USD 120 million in gas debt to Gazprom for the operation of two plants in Russia and the CCHP in Skopje.[31] The exact extent of its gas debt in Macedonia is not known due to the agreement's confidentiality. At the end of 2016, TKG-2 also owed Toplifikacija[32] EUR 23 million, most of which was used for a construction of the CCHP in Skopje.[33] In January 2017, a Russian state-owned bank, VTB, filed a claim with a Russian court to seize the CCHP (which was used as collateral for a loan) in an attempt to use its assets to recover some of TKG's debts to the bank. The difficult financial situation of the ownership of the CCHP has created a cascade of debt that affects the heat distribution company. In theory, this could lead to decapitalization of the company, in turn causing problems with the reliability of supply, or even a temporary halt of the plant's operation, which would risk leaving 50,000 Skopje households without heat.

Oil

Macedonia is completely dependent on crude oil imports from the port of Thessaloniki in Greece, via the pipeline to the OKTA refinery in Skopje. Hellenic Petroleum, partially owned by Greece, purchased the refinery in 1999. Before 2012, Macedonia imported most of its crude oil from Russia (though imports fell from USD 497 million in 2012 to nearly 0 in 2014).[34] In order to cover some of its debt obligations to its international creditors, the Greek government previously offered to sell its state share in Hellenic Petroleum. Both Lukoil and Gazprom expressed interest in purchase.

Currently, Makpetrol is the biggest distributor of oil products to around half of all gas stations in Macedonia. As of 2014, Russia's Lukoil, which represents the second-largest Russian investor in the country, controlled around 9 % of the retail processed fuels market. The Russian company imports its fuel products from a Bulgarian refinery in Bourgas, also owned by Lukoil. In addition to its own chain of 27 gas stations, Lukoil supplies 40 other gas stations with fuel. In 2016, two former partners in a joint venture between Russian TNK and British BP attempted to take over Makpetrol for EUR 47 million. However, Makpetrol was eventually purchased by Balkan Petroleum Holding Limited, a British-Cypriot company that can be traced to the British Virgin Islands.[35] One report links the Balkans Holding company to a Russian-Israeli businessman, Uri Bider, Vasiliy Evdokimov, a British national with links to Russia,[36] and two Russian businessmen, Alexander Kaplan and Mikhail Cerny, about whom allegations of wrongdoing have been made.[37] In July 2017, the Macedonian Security

[31] Skorigina, Nataliya. (2014). The debt of TKG-2 could be covered by China. Komersant, 28.05.2014 accessed on 9 November, 2017 at https://www.kommersant.ru/doc/2480821. TKG-2 is owned by Sintez Group, with significant oil and energy assets in Russia and across Eastern Europe.

[32] TKG-2 (co-owner of TE-TO plant) also have 16.44 % ownership in Toplifikacija through the Cypriot subsidiary, Bitar Holdings. The rest of the company's shares are dispersed among private investors and the company's employees. The stocks of Toplifikacija are publicly traded on the stock exchange.

[33] Letter from a management of Toplifikacija AD to its shareholders regarding an attempt by the Balkan Energy Company to take over TE-TO AD, one of whose shareholders, TGK-2, accumulated debt to VTB Bank, Gazprom Bank and Gazprom, 6 June, 2016, accessed on 21 November, 2017 at www.toplifikacija.mk/Tekstovi/information2016.pdf. Toplifikacija Annual Report for 2016, accessed on 4 January, 2018 at http://www.toplifikacija.mk/Tekstovi/AR2016.pdf

[34] Observatory of Economic Complexity. What does Macedonia import from Russia?, accessed on 16 November at http://atlas.media.mit.edu/en/visualize/line/hs92/import/mkd/rus/show/1995.2015/

[35] Telma (2016). "Carribean Offshore Companies Stand Behind the Takeover of Makpetrol," 6 July, 2016, accessed on 16 November at http://telma.com.mk/vesti/karipski-shor-firmi-stojat-zad-prezemanjeto-na-makpetrol

[36] Dimitrievska, Valentina (2016). "Obscure holding company plans takeover bid for Macedonia's largest fuel retailer," 7 July, 2016, accessed on 16 November at http://www.intellinews.com/obscure-holding-company-plans-takeover-bid-for-macedonia-s-largest-fuel-retailer-101429/

[37] Milmo, Cahal (2012). "Businessman 'boasted of killing US trader," Independent, accessed on 13 July, 2012 at http://www.independent.co.uk/news/uk/crime/businessman-boasted-of-killing-us-trader-7942388.html

and Exchange Commission suspended the takeover, and the relevant Macedonian institutions have not yet reached a final decision in this case.

If a Russian company were to take over Makpetrol, Russia would have a virtual monopoly on the country's oil and gas market, which would expand the Russian economic footprint multi-fold. In neighbouring Bulgaria, Lukoil's controls 50-60 % of the oil market, making it quasi-monopoly in the country.[38] Lukoil has not only been charging higher than international market prices in Bulgaria, but has also been alleged to have used transfer-pricing methods to evade taxes.[39]

Mining and Metallurgy

Solway previously owned a lead-zinc mine, Sasa, and Macedonia's most productive copper and gold mines, Bucim and Pehcevo. Each year, the Sasa processes about 900,000 tons of lead and zinc ore. Solway's investments in the development and expansion of the mines are estimated at EUR 70 million since their acquisition in 2005. Solway however sold Sasa to a U.S. commodities fund in December 2015 and currently operates only Bucim.[40] Solway is officially registered in Switzerland but has links with Rusal Holding, controlled by Oleg Deripaska, an ex-owner of Montenegro's aluminium company, KAP, and widely considered a close ally of the Russian president.[41]

In 2005, Solway acquired Bucim and has since invested over EUR 32.6 million (in modernization and development).[42] Bucim is the biggest local employer, with 600 workers, and has significantly contributed to local infrastructure. Since 2010, Solway has also invested around EUR 4 million in a Pehcevo copper ore mine and has announced plans to increase its investment to EUR 40 million in the future.[43]

In 2010, a Cyprus-based company, Circuitland Developments LTD, purchased an electrical and metallurgy plant, Jugohrom, and became its majority owner with its 90 % of its shares. Circuitland Developments LTD can be traced to a Hong-Kong-based holding company, Camelot Group, owned by Russians Maxim Moskalev and Dimitry Agramakov.[44] In 2016, Jugohrom was closed due to extremely high levels of pollution.[45] The State Inspectorate for the Environment ordered the plant to stop production until further notice.[46]

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[38] Goranova, Kalina and Vassileva, Teodora (2017). „Лукойл" може да не продаде българския си бизнес, Генералният директор на „Лукойл България" Валентин Златев пред „Капитал," Capital Daily, 7 April, 2017, accessed on 10 November at http://www.capital.bg/politika_i_ikonomika/bulgaria/2017/04/07/2950000_Lukoil_moje_da_ne_prodade_bulgarskiia_si_biznes/

[39] E-Burgas (2014). „Рекордни загуби за „Лукойл-Нефтохим". Пазарът на горива става все по-динамичен," e-Burgas, accessed on 16 November at http://e-burgas.com/post/rekordni-zagubi-za-8222lukoyl-neftohim8220-pazarat-na-goriva-stava-vse-po-dinamichen

[40] MiningSee (2015). "Orion mine finance, the owner of Macedonia Sasa lead zinc optimistic in commodities market," 7 December, 2015, accessed on 16 November at https://www.miningsee.eu/orion-mine-finance-the-owner-of-maacedonia-sasa-lead-zinc-optimistic-in-commodities-market/

[41] Smith, Geoffrey (2017). "What to Know About Oleg Deripaska, the Russian Billionaire Who Paul Manafort Worked For," Time Magazine, accessed on 22 March, 2017 at http://time.com/4709452/paul-manafort-donald-trump-vladimir-putin-oleg-deripaska/

[42] Solway – Company website, accessed on 21 November, 2017 at http://www.solwaygroup.com/index.php/our-business/bucim-dooel-radovish-macedonia

[43] MiningSee (2015). "Solway Russian mining company plans 40 MEUR investment in Macedonia copper ore mine Pehcevo," 24 July, 2015.

[44] Xhelai, Neziri (2015). "In the toxic Kingdom of Jugohrom," Center for Investigative Journalism – SCOOP, 21 February, 2015, accessed on 21 November at http://en.scoop.mk/in-the-toxic-kingdom-of-jugohrom/

[45] Meta (2016). "Tomorrow employees from "Jugohrom" will block the intersection outside the courthouse," 23 November, 2016, accessed on 16 November at http://meta.mk/en/tag/jugohrom-en/

[46] SeeNews (2017). "Macedonia extends ban over Jugohrom Ferroalloys plant operations." 31 January, 2017 accessed on 21 November at https://seenews.com/news/macedonia-extends-ban-over-jugohrom-ferroalloys-plant-operations-556220#sthash.Aq0DPI9I.dpuf

Jugohrom, based in Tetovo, was one of Macedonia's top exporters. It accounted for 7 % of total exports and employed 1,100 workers. Although it was among the biggest polluters in the country, it faced little oversight and consequences from the relevant Macedonian authorities. Despite prior investigation by the Tetovo public prosecutor and an indictment in 2014 against the management of Jugohrom on charges of endangering the health of the citizens of Tetovo, the case was dropped on December 5, 2014 due to a lack of evidence of any criminal offense.[47] This changed when it failed to meet a October 31, 2016 deadline set by the State Inspectorate for the Environment to install a dust collection system, and was, as a result, closed.[48]

Box 1. Influx of Russian Offshore Capital: the Case of Samsonenko

One key example of Russian capital flows in the Western Balkans is Samsonenko's network of businesses in Macedonia. Samsonenko is a Russian businessman who came to Macedonia just a few months after Gruevski became Prime Minister in the fall of 2006. Beginning then and continuing to present, Samsonenko was reported to have links with the then-ruling coalition of the Internal Macedonian Revolutionary Organization – Democratic Party for Macedonian National Unity (VMRO-DPMNE).[49] First, a former VMRO Member of Parliament (MP) (from 1998 to 2002), Aleksandar Pandov, worked as a manager in Samsonenko's BetCity gambling business until 2011.[50] Second, Samsonenko publicly appeared in a pre-election music video commissioned by VMRO-DPMNE in 2014, in which he openly supported Gruevski.

Samsonenko's investments have been concentrated in sports and gambling. In addition to BetCity, Samsonenko owns the football and handball club Vardar. His biggest direct investment in the country is a 2014 public-private partnership between one of his companies and the municipality of Aerodrom (at that time governed by a VMRO-DPMNE mayor) to build "Sport Center Jane Sandanski." The municipality gave Samsonenko a 35-year concession for the sports hall through a procedure that appeared to be neither competitive nor transparent. The company managing the sports hall[51] is a Cypriot-based offshore company owned ultimately by a Belize-based shell company used by Samsonenko for many of his other investments. In addition to Samsonenko's businesses, many companies associated with the Macedonian political elite close to Gruevski are registered at the same addresses in the offshore jurisdictions used by Samsonenko himself.[52]

[47] Xhelal, Neziri (2015). "In the toxic Kingdom of Jugohrom", Center for Investigative Journalism – SCOOP, 21 February, 2015, accessed on 21 November at http://en.scoop.mk/in-the-toxic-kingdom-of-jugohrom/

[48] Dimitrievska, Valentina (2016). "Top Macedonian exporter Jugohrom faces shutdown over air pollution". IntelliNews, 1 November, 2016.

[49] Lefkov, Goran (2016). "Samsonenko: Successful in Macedonia-under scrutiny in Russia". Center for Investigative Journalism – SCOOP, 5 December, 2016.

[50] SCOOP (2016). "Samsonenko: Successful in Macedonia-under scrutiny in Russia," Center for Investigative Journalism – SCOOP, 5 December, 2016 accessed on 16 November at http://en.scoop.mk/samsonenko-successful-in-macedonia-under-scrutiny-in-russia/ and Nova TV (2015). "The Russian Samsonenko in the story "Invest in Macedonia Belize", 6 February, 2015, accessed on 16 November at http://novatv.mk/rusinot-samsonenko-vo-prikaznata-invest-in-masedonia-via-belize/

[51] Samsonenko has also built a big hotel attached to the sport center.

[52] http://novatv.mk/rusinot-samsonenko-vo-prikaznata-invest-in-masedonia-via-belize/

Political Meddling and Soft Power

Russia has also gained a foothold in the Macedonian public space through its media outlets, such as Sputnik, and its non-profit organizations, including charitable activities. Some of these Russian organizations have donated funds to construct Orthodox churches or promote Russian culture and language. Russia's public relations campaign relies heavily on promoting Russia's historic ties to Slavic nations in the region as a way to improve the public perception of its institutions. Pro-Russian media and non-profits often present Russian governance as an alternative to the EU, which they describes as hypocritical in its approach to the Western Balkans.

Russia has allegedly financed the construction of a Russian Orthodox Church in the Aerodrom municipality of Skopje, which also hosts a sports center, co-financed by Samsonenko and the municipality.[53] The same foundation was previously associated with financing the pro-Russian Center Party in Estonia.[54] Meanwhile, a member of the Russian Duma, Leonid Lebedev, also a beneficiary of the Skopje TE-TO heating plants, donated funds for lighting the Millennium Cross above Skopje.[55]

Although the Gruevski government attempted to boost Russian tourism to Macedonia by scrapping short-term visa requirements for visits of less than one year, the number of tourists from Russia has remained small, at between 2,400 and 4,800 per annum. The latter trend is not helped by the lack of a direct flight connection and the limited promotion of the country in Russia. In comparison, more than 300,000 Russians on average visit Montenegro each year.

Russia emerged as a political player in Macedonia after the country plunged into a political crisis following April 2014 elections. The Social Democratic Union of Macedonia (SDSM), an opposition party, left the Macedonian parliament because it claimed that the elections were illegitimate and demanding a new vote. Gruevski's determination not to back down unleashed a wave of street protests. The political crisis deepened after a leader of the SDSM began releasing wiretaps revealing high-level corruption and even alleged murder plots. The recordings appeared to have the voices of Gruevski, the Secret Services head Sasho Mijalkov (Gruevski's first cousin), and the Transportation and Interior ministers discussing public procurement tender manipulation, appointments of loyalists to senior judicial positions, suppression of protests, abuse of public funds for conspicuous consumption, and cover-ups of the murder of a youth who attended earlier protests.

As the protests turned violent, the EU negotiated the so-called Przino agreement between the government and the opposition, which stipulated the resignation of Gruevski's government, new elections, and appointment of a special prosecutor to investigate the corruption allegations stemming from the wiretapped recordings. However, the crisis was exacerbated in 2016 following inconclusive elections and the attempt by Macedonia's president to pardon the individuals charged in or allegedly involved in the publicized corruption scandals. Eventually, the president backtracked and rescinded the pardon in the face of national and international protests, including from the EU. Finally, once a new coalition government headed by Zoran Zaev and his SDSM party formed a government on May 31, 2017, the country returned to relative stability.[56]

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[53] Braw, Elisabeth. (2015). "Mixed Feelings In Macedonia As A Russian Orthodox Church Rises". 25 June, 2015, accessed on 16 January, 2018 at https://www.rferl.org/a/macedonia-russian-orthodox-church-skopje/27093507.html

[54] RWR (2015). "Economic and Financial (E&F) Threat Assessment for Macedonia: Assessing the Activities of Russian State-Owned Enterprises in Macedonia," 2 December, 2015.

[55] Kuzmanovski, Blagoja. (2015). Is Russia Showing Special Interest in Macedonia?, RadioFreeEurope, 25 March, 2015, accessed on 16 January, 2018 at https://www.slobodnaevropa.org/a/is-russia-showing-special-interest-in-russia/26919885.html

[56] Marusic, Sinisa. (2017). "Macedonia Parliament Approves New Gov't after Prolonged Stalemate". BalkanInsight, 31 May, 2017, accessed on 13 January, 2018 at http://www.balkaninsight.com/en/article/macedonia-parliament-approves-zaev-s-new-govt-05-31-2017

Throughout, there were indications that the Russian government was using the political crisis to reawaken national rifts in the region and to find "evidence" to back claims of Western meddling, including allegations of stoking the protests and pushing for a change in government.[57] The Gruevski government, as well as Macedonian President Gjorge Ivanov, repeated many of Russia's claims.[58] Russian Foreign Minister Lavrov stated that the protests in Macedonia were the product of outside manipulation.[59] Lavrov had been commenting on the situation in Macedonia beginning with the protests in 2015, when he drew upon ethnic divisions and sensitivities, claiming that Macedonia had been a victim of extremism and would be divided by Albania and Bulgaria. Later, after the December 2016 elections, Russia focused attention on an alleged "Tirana Platform" to create a "Greater Albania." In government statements, Russia played up the poor state of inter-ethnic relations, with great resonance in Macedonia and the region. In general, Russian Foreign Ministry statements became a regular occurrence after 2015. Prior to these protests, Russia had largely ignored Macedonia. Against this backdrop, the Macedonian government refused to join the EU and U.S. sanctions against Russia after the Crimean annexation. Ivanov was also invited to join the May 9, 2015 military parade in Moscow amid a boycott of the event by most world leaders.[60]

The poor state of media freedom in Macedonia contributed to the ability of Russian messages to enter the mainstream media. Pro-government media outlets and then-Prime Minister Gruevski himself borrowed narratives from Russian media outlets such as Sputnik. Outside the panic-raising reports about the West promoting a Greater Albania project, the U.S. Ambassador also became a target of a pro-government media campaign.[61]

An investigative report from June 2017 by the Organized Crime and Corruption Reporting Project (OCCRP) and several local and regional investigative organizations revealed information from leaked Macedonian counterintelligence documents portraying how Serbian intelligence had been involved in efforts to support anti-Western and pro-Russian nationalist groups.[62] The documents also revealed how the Russian Embassy in Skopje had been engaged in propaganda and subversive activities since 2006, which included direct funding of Macedonian media outlets, including those directed at the Albanian minority, so that they become outlets for Russian disinformation.[63] The Russian foreign intelligence (SVR) bureau in Belgrade and the military intelligence (GRU) office in Sofia were reportedly managing the operations in Macedonia. In addition, Russia has set up over 30 Russo-Macedonian cultural associations, opened a Russian cultural center in Skopje, and opened two Consulates in Ohrid and Bitola in 2016, allegedly with the goal of gathering intelligence.[64]

Apart from some Russian intelligence officers, leaked documents identified some journalists from TASS, a state-owned Russian news agency, and a representative of the Rossotrudnichestvo Russian aid agency to have worked on recruiting Macedonian officials.[65] A Rossotrudnichestvo office opened in Macedonia in 2016 as a result of a 2013 intergovernmental agreement envisioned the founding of a Russian cultural and science center in Macedonia.[66] The leaked coun-

[57] Rettman, Andrew (2017). "EU and Russia step into Macedonia crisis," EUObserver, 3 March, 2017.

[58] Marusic, Sinisa (2016). "Macedonia's Gruevski Issues Threats," BalkanInsight, 17 December, 2016.

[59] Holodny, Elena. "The Kremlin thinks that the massive protests rocking a Balkan nation are an outside job to hurt Russia," Business Insider, 20 May, 2015 accessed on 11 November, 2017 at http://www.businessinsider.com/russia-lavrov-macedonia-protests-2015-5

[60] Ivanov was also made doctor honoris causa by the Russian foreign relations academic institute – MGIMO.

[61] Ibid.

[62] OCCRP (2017). "Leaked Documents Show Russian, Serbian Attempts to Meddle in Macedonia," 4 June, 2017.

[63] Ibid.

[64] Ibid.

[65] Ibid.

[66] Website of the Rossotrudnichestvo office in Macedonia accessed on 6 December at http://mkd.rs.gov.ru/ru/about

terintelligence documents also noted that the Russian Ambassador directly told a senior foreign ministry official in April 2017 that Russia was working to make Macedonia, Bosnia and Herzegovina, Montenegro, and Serbia militarily neutral countries and complained that the Macedonian government was not reciprocating Russia's support, and threatened it with economic and political consequences.[67]

Policy Recommendations

The immediate goal of Russia's economic policy in Macedonia has been to maintain its regional dominance over energy markets and galvanize support for its gas pipeline projects in the region. Control of energy markets is the basis on which Russia could try to step up its efforts to expand both its economic engagement and political influence. By trying to lock Macedonia in large-scale energy projects, Russia has been working towards pressuring the government over the long-term, potentially through energy supply halts, debt disputes, or trade restrictions. To bolster the resiliency of its economy and political system against the inflow of corrosive capital, the Macedonian government should strengthen the governance of its key institutions, put economic considerations before geopolitical assumptions, improve media freedom, make capital inflows more transparent, and tackle high-level corruption that could be used by foreign countries, entities and individuals for their own interests.

Several key policy recommendations include:

- Macedonia should create an independent department within the Financial Intelligence Office (FIO) to monitor and analyze capital flows from foreign countries. Its task would be to flag suspicious money flows into strategic economic sectors and in sensitive areas, such as cultural and media institutions.
- The FIO and the Special Prosecutor's Office should look more closely at ties between domestic political parties and businessmen and foreign businesses, particularly from authoritarian countries, especially when there is little transparency about the origin of large-scale transactions aiming to acquire lucrative assets in the country.
- Macedonia should work on strengthening the independence of media by reforming the media regulator and developing a special unit targeting disinformation campaigns that pose threat to national security.
- To promote healthy investment in the country, Macedonia should demand transparency of ultimate beneficial ownership, and should closely monitor and analyze money laundering and tax evasion risks.
- Macedonia should focus its efforts in the energy sector on diversification of gas supplies and liberalization of gas and power markets, consistent with European energy rules.
- Regulatory institutions such as the country's Security and Exchange Commission (SEC) should not allow the ownership of the largest oil refining and wholesale distribution assets to be acquired by companies with unidentified ultimate beneficial ownership and financial capacity. The SEC should ensure full transparency of its decision-making process, in which the FIO and the Energy Regulatory Commission (ERC) should also be involved.
- A detailed cost-benefit analysis of each large-scale infrastructure project conducted by independent consultants should be performed before the government commits to them. Foreign financial institutions, such as the European Bank for Reconstruction and Development, the European Investment Bank and the World Bank, could be engaged in advising the government on the most efficient public investment frameworks.
- The capacity and independence of energy and environmental regulatory bodies, as well as judicial institutions should be strengthened, so that they can prevent and respond to violations of respective frameworks.
- Mergers and acquisitions should be closely monitored by Macedonia's Commission for Protection of Competition for possible market concentration risks, even when the deals affect foreign companies investing in Macedonia.

[67] Ibid.

- Private businesses and CSOs should advocate against non-transparent decision-making in strategic sectors such as energy, mining and finance that potentially attract the attention of corrosive capital.
- Civil society organizations and investigative journalists should become much more active in reflagging and exposing corrupt practices, the fusion of corporate and political interests, and irresponsible and opportunistic economic policies.

CENTER FOR
THE STUDY OF
DEMOCRACY

ASSESSING RUSSIA'S ECONOMIC FOOTPRINT IN SERBIA

Policy Brief No. 72, January 2018

Overview

Russia's economic footprint has been growing in the Western Balkans for at least a decade. The gradual takeover of the Serbian energy sector by Russian state-owned and -affiliated firms is the most visible manifestation of this trend. Russian firms and their Serbian domestic intermediaries have targeted in particular large companies with weak corporate governance. Because these companies typically have only a handful of capable managers, Russian and associated Serbian entities have been able to win largely uncontested and in many cases unilaterally enriching contracts. Among the four countries under this study, the Russian economic footprint in Serbia is the largest in terms of Russian companies' revenue as a share of the total turnover of all Serbian businesses. Russian entities, directly or indirectly, affect as much as 10 % of the Serbian economy. Notably, Russia's corporate presence, measured by volume of revenue and assets controlled by Russian companies in Serbia, is even larger than in Montenegro, where Russian foreign direct investment (FDI) is a third of the country's gross domestic product (GDP).

There are two main, interconnected factors in Russo-Serbian relations that have laid the foundations

KEY POINTS

- There are two main factors that have laid the foundations for Russia's expanded presence in Serbia: Russian support for Serbia's non-recognition of Kosovo and the 2008 energy agreement.
- Russian-owned or indirectly linked firms in Serbia control revenues of close to EUR 5 billion, or 13 percent of the total revenues generated by the local economy.
- The indirect Russian footprint has different forms, including: 1) local companies' dependence on Russian raw material imports, i.e. natural gas; 2) debts accumulated for gas supply; and 3) domestic companies' dependence on exports to Russia and/or Russian-controlled bank loans, for example Agrokor's subsidiaries.
- In addition to the corporate investments, Russia has used direct government-to-government loan schemes to expand its footprint in the Serbian economy.
- The Russian economic footprint is most visible in the energy sector, where Gazprom and Lukoil dominate the oil and fuels markets; Serbia is almost fully dependent on natural gas imports from Russia; and local politically-connected intermediaries prevent supply diversification and market liberalization.
- Russia has compounded its political ties with Serbia and its economic presence in the country by leveraging traditional pro-Russian, pan-Slavic, and pan-Orthodox attitudes via a series of Russia-inspired soft power initiatives.

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for Russia's expanded power in the country. One is Russian support for Serbia's non-recognition of Kosovo's unilateral declaration of independence, and the second is a 2008 energy agreement that included Gazprom's takeover of Serbia's largest Serbian company, the oil and gas firm Naftna Industrija Srbije (NIS). The agreement sold NIS at a below-market price and approved a new long-term contract with the Yugorosgaz intermediary company, which, in effect, appears to be a shell company majority-owned by Gazprom. The 2008 agreement also included provisions for Serbia to join the South Stream project. Although work on the project ended in December 2014, South Stream's dominance over the Serbian energy agenda for the past decade slowed key diversification projects, market liberalization efforts, and the implementation of critical EU energy commitments. Moreover, Russia has effectively reincarnated the South Stream project as Turkish Stream, which could be read as a continued attempt to lock Serbia into an asymmetrical energy relationship.

Gazprom's terms in the 2008 natural gas agreement have weakened the financial solvency of the state-owned wholesale gas supplier, Srbijagas, and have ballooned the debt of other petrochemical and large industrial companies. High import prices dictated by Gazprom and the limited liberalization of the domestic market have caused a large accumulation of debt in the energy sector (primarily in the state-owned gas supplier, Srbijagas). The gas debt accumulated in the energy sector has, over time, translated into state debt, which severely limits the country's financial firepower.

Moreover, the far-reaching energy agreement appears to have energized Russian involvement in other sectors of the Serbian economy. For example, Russia has sought economic cooperation in railway infrastructure projects and the banking industry. Although in comparison with Serbia's total trade with the EU and the EU's investments in Serbia, Russia's economic presence is comparatively small, the Russian footprint is concentrated in several strategic sectors that affect the whole economy.

Over the past decade, Russia has compounded its political ties with Serbia and its economic presence in the country by leveraging traditional pro-Russian, pan-Slavic, and pan-Orthodox attitudes via a series of soft power initiatives. Sputnik, a Russian state-owned media company, has worked with some Serbian media owners to provide content directly through their local branches. Whether directly or indirectly, the promotion of ideas sympathetic to Russia provides a narrative to the Serbian population that appeals to anti-NATO and anti-EU sentiments.

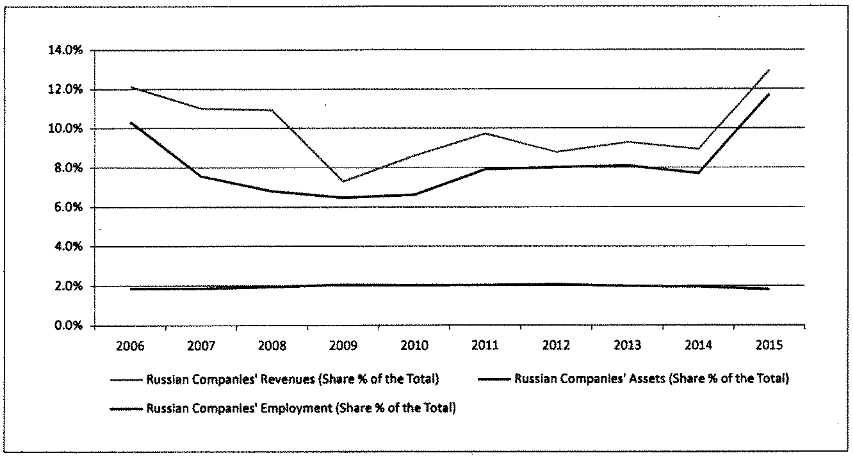
Moreover, Russia has used high-level political visits to strengthen political ties and impress upon ordinary Serbians that Russia is a strong foreign policy actor and ally. In the background, Russian companies and Russian officials have built networks that take advantage of Serbian governance deficits, such as opacity in economic decision-making, the lack of accountability among the management of state-owned companies and a lack of regulatory independence.

Russia's Economic Footprint in Serbia

Russia's effort to increase its political and economic leverage in Serbia dates back to 2008, when Russia sided with Serbia's position against Kosovo's declaration of independence. Russia's support for Serbia's stance coincided with the takeover of NIS and the commitment by Serbia to join Russia's South Stream pipeline initiative, which defined the energy policy thinking of Southeastern European policy-makers for ten years.[1] Gazprom also gained control over the wholesale gas supplier, Srbijagas, via a long-term gas import contract that utilizes a politically-connected intermediary company, Yugorosgaz. This intermediary is controlled by Gazprom and managed by a board of directors, one member of which is Srbijagas' CEO who

[1] Polterman, Andreas. "Serbia Caught between Two Chairs? Does Serbia Want to be Part of the Russian Sphere of Influence or Join the European Union?" Heinrich Böll Stiftung in Serbia, Montenegro and Kosovo, 10 December, 2014.

Figure 1. Russia's Corporate Footprint in Serbia



Source: *CSD calculations based on a commercial corporate database survey using ultimate beneficial ownership as criteria.*

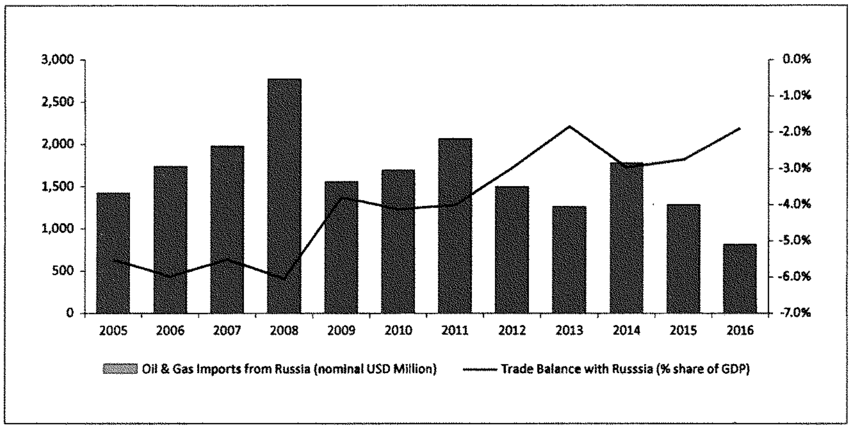
is a Vice President in the government's junior coalition partner, the Socialist Party.

Russia has firmly entrenched itself in the Serbian oil and gas sector. Serbia imports close to 65 percent of its natural gas needs and more than 70 percent of its crude oil consumption from Russia. However, the fall of energy prices since 2014 pushed down Serbia's oil and gas import costs from USD 2.06 billion in 2011 to just USD 812 million in 2016, or from 5.4 percent to 1.8 percent of Serbian GDP (see Fig. 2). Correspondingly, as energy resource imports make up most of the bilateral trade between the two countries, the Serbian trade deficit with Russia has also dropped significantly. Although these factors have decreased the financial burden from excessive dependence on one supplier, Russia remains the country's most important energy partner. Critically, Russia still dominates Serbia's domestic oil and gas production via ownership stakes in NIS, and controls the wholesale and retail fuel market through Gazprom Neft and Lukoil.

Apart from the energy sector, Russian FDI in Serbia has remained small. From 2005 to 2016, Russian investment amounted to 4 percent on average annually of all FDI in Serbia. Russia invested a total of around USD 1.1 billion, or a bit less than 3 percent of Serbian GDP over this period. However, this figure underestimates the true value of Russian investment in the country; for example, our research shows that NIS, Lukoil and Sberbank, among others, have invested in Serbia through intermediary states such as Austria and Netherlands. NIS has invested at least USD 1 billion since Gazprom's purchase of it in 2008, and Lukoil has invested additional USD 250 million. Hence, a more realistic estimate of total Russian FDI (including indirect investments) would be around USD 2 billion, or 6 percent of the country's GDP.

In addition to corporate investments, Russia has used direct government-to-government loan schemes to expand its footprint in the Serbian economy. During the Serbian fiscal crisis in 2012 – 2013, Serbia asked Moscow for a loan to buttress the Serbian budget. This could be read as an effort to avoid asking for assistance from the International Monetary Fund (IMF), which would require structural reforms. Russia agreed to lend Serbia USD 500 million and disbursed USD 300 million immediately

Figure 2. Oil and Gas Imports and Trade Balance with Russia



Source: *CSD calculations based on data from the National Statistical Agency of Serbia.*

to keep the country afloat. At the same time, Serbia borrowed additional USD 800 million from Moscow to modernize the country's outdated railway infrastructure. At an annual interest rate of 4.1 percent, the Russia loan had less favorable conditions than typical loans from European development financial institutions such as the European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB). Moreover, the second loan granted preferential status to Russian state-owned contractors for the infrastructure modernization projects.[2] This loan was not debated publically, and it seems that Serbia agreed to the terms of exclusive access for Russian contractors in violation of EU norms on competition and transparency in public procurement. Moreover, the loan negotiations happened concurrently with negotiations between Gazprom and Srbijagas for the 10-year gas supply contract.

The result was a long-term contract to deliver up to 5 billion cubic meters (bcm) per year of natural gas, twice the amount of gas supplied by Gazprom from 2001 to 2011 and 40 percent more than Serbia's average annual gas demand. However, Gazprom set a 1.5 bcm minimum threshold for the annual volume of Serbian gas purchases, somewhat alleviating the initial worries that Serbia would be paying for much more gas than it actually needs.[3] On December 19, 2017, Yugorosgaz and Gazprom signed an addendum to the Russian gas supply contract to increase the volume of gas supplies to Serbia from 1.5 bcm to 2 bcm, starting from 2018, although Serbia imported only 1.75 bcm in 2016.[4] The contract's amendment came on the tail of two preliminary agreements between Gazprom and Serbia to expand transmission and storage facilities, including that of Banatski Dvor, an underground gas storage facility from 450 to 750 million cubic meters (mcm).[5]

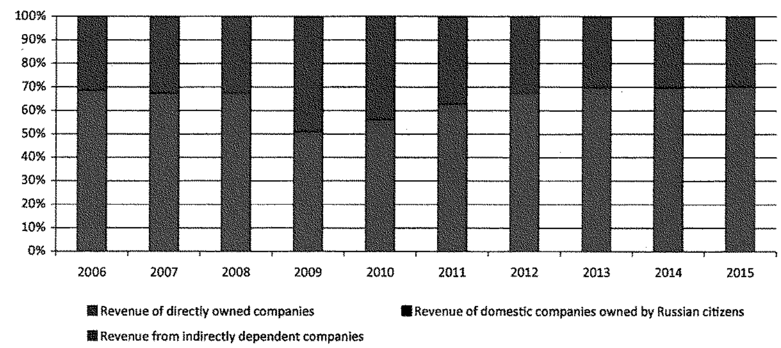
[2] For example in June 2017, the German development bank, KfW, lent Serbia EUR 17 million for new water supply infrastructure. See https://seenews.com/news/serbia-gets-17-mln-euro-loan-from-kfw-for-water-supply-projects-571661

[3] Reuters (2011). "Srbijagas agrees 10-yr gas import deal with Gazprom," 21 December, 2011, accessed on 24 November at http://www.reuters.com/article/serbia-gazprom-gas/srbijagas-agrees-10-yr-gas-import-deal-with-gazprom-idUSL6E7NL4H320111221

[4] Gazprom Export webpage dedicated to the relations with Serbia, accessed on 2 January, 2018 at http://www.gazpromexport.ru/en/partners/serbia/

[5] Ibid.

Figure 3. Structure of Russia's Corporate Presence in Serbia



Source: *CSD calculations based on data from a commercial corporate database.*

During Serbia's fiscal crisis, Russia further deepened its presence in the Serbian economy through loans, contracts, and investments. In our view, Russian state-administered and -controlled companies have won favorable repayment terms, gained preferential treatment to work in country, and forced unnecessary energy purchases on the country's balance sheet. The renegotiation of the natural gas contract has significantly changed the Serbian energy import scheme and has gone largely unnoticed by the public. A Russian-owned company effectively took control of the Serbian natural gas sector without much public discussion.

Russia's economic presence is most salient in the corporate arena. In Serbia, approximately 1,000 companies are entirely or partly Russian-owned.[6] Russian-owned or -connected firms in Serbia control revenues of close to EUR 5 billion, or 13 percent of the total revenues generated by the local economy. As will be described below, the indirect footprint of Russian companies takes different forms, including: 1) local companies' dependence on Russian raw material imports, i.e. natural gas; 2) debts accumulated for gas supply; and 3) domestic companies' dependence on exports to Russia or Russian-controlled bank loans, for example Agrokor's subsidiaries.

Meanwhile, Russian entities directly or indirectly control between 8 percent and 10 percent of all assets in the Serbian economy. This is despite the lower-than-market valuation of NIS' oil and gas reserves and the decapitalization of some petrochemical plants, the gas debt of which has been transformed into equity for Gazprom. Russian state-owned and private oil and gas companies own almost all domestic oil and gas reserves, control over half of the wholesale and retail fuels markets, and indirectly affect the financial management and corporate governance of state-owned gas supplier Srbijagas, as well as that of its important industrial clients. Russian companies are also major employers in the country, directly employing approximately 2 percent of the total labor force and indirectly employing around 5 percent (roughly 70,000 people in total). Such employment is concentrated in just a few industrial enterprises.

Two of the biggest Russian-led mergers and acquisitions in the energy sector are Lukoil's takeover of Be-

[6] According to an analysis of company data in a commercial corporate database.

opetrol in 2003, and NIS and Lukoil's buy-up of shares in petrochemical plant Petrohemija. After the latest conversion of Petrohemija's debt into its ownership in 2017, NIS and Lukoil own around 23 percent of its shares, while the rest is in the hands of state-owned companies including Srbijagas (32 percent). Srbijagas has been involved in the partial takeover of several of its gas clients, including Azotara and MSK, and even companies in other industries such as Srpska Fabrika Stakla, Toza Marković, and Agroživ. All these companies accumulated large gas debts with the national supplier.

Russian presence in the finance, banking, and insurance sectors is limited but has expanded significantly in the past years, as three Russian-owned banks, Sberbank,VTB (state-owned) and Expobank entered the market. However, their market share is minimal, as they are not among the top 10 biggest banks in the country. There is the possibility that the 2017 Agrokor crisis could increase Sberbank's footprint via an expanded share in Agrokor's debt-ridden subsidiaries in Serbia, including Merkator-S, the biggest retail chain in Serbia.

Furthermore, exports to Russia have become an important aspect of the economic relationships between Russia and Serbia, following the expansion of the free trade agreement signed in 2000. A Russian embargo on the import of EU agricultural and food products has provided a boost to exports from non-EU countries in the Western Balkans. Since 2011, Russia has ranked consistently among the top five export destinations for Serbian goods, with more than 5 percent of all Serbian exports ending up in the Russian market, which contributes to about 2 percent of the Serbian economy. Between 2005 and 2015, Serbian exports to Russia rose four-fold to more than USD 1 billion, the largest amount by volume for the Southeastern European region after Greece.

Even though Serbian officials continue to emphasize that the free trade agreement is a unique instrument that will enable more rapid economic development in Serbia, the true effects of this agreement on Serbian exports have been humble at most.[7] Several obstacles persist; in particular, Russia maintains strict import criteria, and Serbia has only modest production capacity. Some of Serbia's most valuable manufactured goods are not on the list of duty-free products in Russia. For example, Russian officials on several occasions did not grant Serbian-produced Fiat cars duty-free status, while Serbia's exports to Russia are predominantly machinery and transport equipment, medical and pharmaceutical products, and agricultural products. In 2016, 815 Serbian companies exported goods to the Russian market. A quarter of all Serbian exports to Russia have been in agricultural goods because of the Russian embargo on EU-produced agricultural goods. In June 2017, Mlekara Sabac, one of the largest dairy companies in Serbia, which exports 75 percent of its white cheese to Russia, announced that it would build a factory in Russia with a production capacity of 450 tons of milk, equivalent to the output of some of the biggest dairy farms in the Western Balkans.[8]

Vulnerable Sectors

Energy

Serbia is an energy-poor country that imports much of its energy resources, with the exception of coal. The country has limited oil and gas reserves, with 77.4 million barrels and around 4.8 bcm in storage, respectively. Currently, the only two gas supplies in Serbia are from local gas fields in Vojvodina, and Russian imports via Hungary and Ukraine (the Beregovo metering station).[9] Local gas production currently satisfies only 16 percent of Serbia's needs and, despite some exploration activity since 2010, it is difficult to imagine a significant increase in pro-

[7] Xinhua (2017). *"Russia wishes to further strengthen ties with Serbia: Russian official,"* 6 June, 2017, accessed on 24 November, 2017 at http://news.xinhuanet.com/english/2017-06/06/c_136342229.htm

[8] Ralev, Radomir (2017). "Serbian dairy group Mlekara Sabac to build factory in Russia," SeeNews, 2 June, 2017, accessed on 2 January at https://seenews.com/news/serbian-dairy-group-mlekara-sabac-to-build-factory-in-russia-570858#sthash.t2ujHljr.dpuf

[9] Energy Community. (2017). Serbia Gas Chapter in the 2017 Annual Implementation Report. October 15, 2017.

duction. The share of imports in crude oil dropped from approximately 80 percent in 2006 to about 60 percent in 2015, because of renewed exploration activity by NIS.[10] Due to the high share of coal and hydropower in overall electricity production, Serbia is one of the least electricity-dependent countries in Southeastern Europe. Coal, mainly domestic lignite, represents 53 percent of gross inland energy consumption.[11] Nonetheless, 47 percent of Serbian energy consumption is imported from Russia.

It is through the energy sector that Russia truly exerts its economic leverage in Serbia – one of the hardest hit countries in the wake of the 2009 gas supply crisis. The country's gas imports are fully dependent on Russia and the supply pipeline route through Ukraine, Slovakia, and Hungary. Instead of seeking to diversify its gas supply through strategic pipeline interconnectors with Bulgaria and Croatia, Serbia has remained an energy island that has devoted considerable effort to promoting Gazprom-controlled pipelines. Not surprisingly, Serbia pays one of the highest gas import prices in Europe, which has dissuaded local residents from pursuing domestic gasification and has pushed them out of the district heating systems that use natural gas in large urban centers, and into burning coal and wood, as well as using electricity for heating purposes.

In 2016, Serbia's oil and gas imports (mainly from Russia) accounted for less than 2 percent of the country's GDP, down from over 5 percent in 2005. Yet Russia has firmly occupied a crucial decision-making position in the energy sector in Serbia for the past decade. In 2008, Serbia concluded a wide range of intergovernmental 30-year agreements, including the sale of 51 percent of then-state-owned NIS to Gazprom, as well as a majority stake in the country's only gas storage facility, Banatski Dvor, for a total of USD 400 million. Russia bolstered the agreement with a firm pledge to build the 63-bcm gas pipeline, South Stream, which would cross the Black Sea before crossing Bulgaria, Serbia, and Hungary, ending at Austria's Baumgarten hub. Although the project has since been shelved, South Stream captivated the imagination of Serbian energy policy-makers for the six years it was active. For example, at the outset, Srbijagas founded a joint project company with Gazprom to build Serbia's portion of the South Stream pipeline. According to an investigative report by *Insider*, the national gas supplier spent roughly USD 35 million for the project's preparatory activities.[12] However, in reality there has been no visible progress in the completion of the pipeline in both the feasibility and engineering parts of the project.

If Serbia wanted access to the windfall of benefits that South Stream could provide, it would have had to accept other unsatisfactory conditions, including not completing alternative projects providing for potential future gas diversification. For example, by focusing entirely on South Stream, Serbia did little to advance the strategic gas interconnector with Bulgaria, which could establish an alternative gas supply route from Azerbaijan via the Greece-Bulgaria interconnector and the Trans-Adriatic Pipeline. Despite a Bulgarian-Serbian intergovernmental agreement on the construction of the interconnector in 2017, no concrete steps have been taken to complete the project; funding has not yet been sourced and a project management company has not been set up.

When the South Stream project fell apart in 2014 due to the objections of the European Commission to the pipeline project's violation of EU energy and competition law, the Russian president replaced South Stream with Turkish Stream in December 2014, and proposed the hastily-designed extension TESLA. TESLA is supposed to link to the proposed Turkish Stream project and bring Russian gas to Europe through Greece, Macedonia, Serbia, Hungary, and end in Austria. Turkish Stream has a proposed

[10] According to the Serbian energy balance statistics of the International Energy Agency accessed on January 2, 2018 at https://www.iea.org/statistics/statisticssearch/report/?country=SERBIA&product=oil&year=2006

[11] Data from the European Energy Community, 2012.

[12] In 2016, a team of investigative journalists tried to uncover where the amount of 30 million EUR was invested and why. They were however left without any answer. See "Plaćamo i za ugašeni projekat Južni tok?" Insider, 11 March, 2016, https://insajder.net/sr/sajt/tema/454/

Table 1. Gas Import Prices in Serbia (USD/1,000 cubic meters)

Year	January-March	April-June	July-September	October-December	Average
2004	118	121	124	134	**125**
2005	147	157	177	207	**167**
2006	228	224	255	166	**248**
2007	265	248	252	283	**271**
2008	339	382	447	496	**416**
2009	440	334	245	273	**323**
2010	327	357	372	374	**357**
2011	384	420	478	483	**441**
2012	477	491	491	497	**489**
2013	419	410	397	396	**405**
2014	390	395	398	390	**394**
2015	350	286	235	199	**267**

***Source:** Presentation "Пословање ЈП Србијагаса у 2015 и очекивања у 2016 години," Srbijagas, March. 2016, p. 9.*

capacity of 31.5 bcm,[13] of which Turkey expects to consume about 16 bcm.

Kosovo's unilateral declaration of independence in February 2008 appears to have catalyzed the 2008 energy agreement between Russia and Serbia. It appeared that the Serbian leadership at the time sought to bring Russia into the Western Balkans as a counterbalance to the West. Since the early 1990s, the success of Russian energy policy in Serbia typically relied on close connections to the senior leadership of the Serbian Socialist Party (SPS). The links established between SPS and Gazprom were revived in the second half of the 2000s, when senior SPS members rose to high management positions in many state-owned energy companies. With the 2008 agreement, Gazprom gained a bigger-than-ever say in the financial management and governance of Srbijagas. For instance, Dusan Bajatovic serves as both a CEO of the national gas supplier and a Vice President in the SPS. The Serbian media considers him the principal pro-Gazprom player in Serbia. Bajatovic has kept his position for almost a decade with alleged support from Moscow.[14] Additionally, Serbia's Anti-Corruption Agency claimed in 2014 that his corporate positions could be a source of conflicts of interest,[15] but he has so far defied the criticism.[16] Bajatovic has openly opposed gas supply diversification, an otherwise widely popular concept that would lower gas prices for Serbia. Strikingly, on a number of occasions, he has even expressed on-the-record viewpoints that directly conflict with some of the government's and energy ministry's proposals.

The asymmetrical relationship between Gazprom and Serbia has indirectly affected the financial health of a range of gas-dependent companies. State-owned firms accumulated EUR 200 million in debt to Srbijagas between 2006 and 2013, due to Gazprom's price

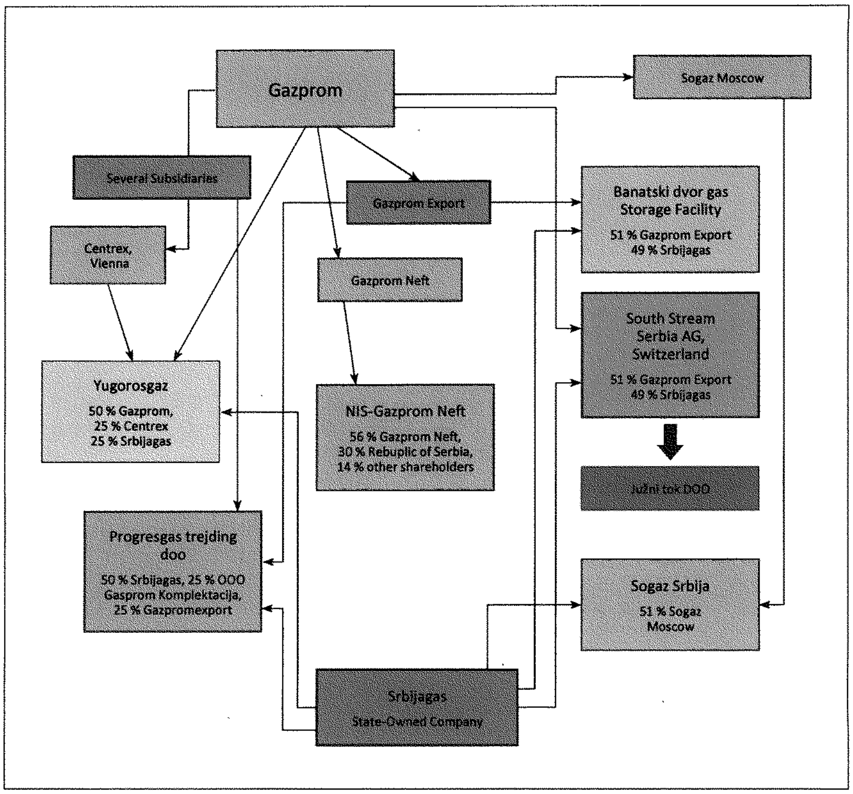
[13] "Perspective for 'Turkish Stream' Project: Possible Scenarios and Challenges," Natural Gas World Website, 27 January, 2017, https://www.naturalgasworld.com/perspective-for-turkish-stream-project-possible-scenarios-and-challenges-35401

[14] For example see G.V, "Ruska drugarska podrška Bajatoviću," Danas, 1 April, 2016 http://www.danas.rs/danasrs/ekonomija/ruska_drugarska_podrska_bajatovicu.4.html?news_id=258344 and "Rusi ne daju Bajatovića", Novi Sad news portal 021, May 17, 2016, http://www.021.rs/story/Info/Srbija/135604/Rusi-ne-daju-Bajatovica.html

[15] "Case – Dušan Bajatović", Anti-Corruption Agency of the Republic of Serbia, 18 September 2014, accessed on January 18, 2018 at http://www.acas.rs/wp-content/uploads/2015/09/Dusan-Bajatovic-slucaj.pdf?pismo=lat

[16] Biljana Baković, "Kako je Bajatović zadržao sve funkcije," Politika Online, 10 April, 2016. http://www.politika.rs/sr/clanak/352864/Politika/Kako-je-Bajatovic-zadrzao-sve-funkcije

Figure 4. Gazprom Ownership Tree in Serbia



Source: *CSD description based on a commercial corporate database analysis.*

policies and its inflexible long-term gas import contract. These financial losses are a result of the mismatch between the high price of gas imports and the low domestic price paid by consumers. It appears that domestic consumer prices are heavily subsidized, in part to prevent social unrest. Moreover, Srbijagas has been unable to pursue its claims on the debts accumulated by several large state-owned enterprises (SOEs), such as Azotara Fertilizer Plant, Petrohemija, Smederevo Steel Mill, and some municipal district heating companies, as this could make the companies insolvent, endangering thousands of jobs or even the heating supply to big cities. Ultimately, a considerable part of Serbian heavy industry has depended on the supply of cheap natural gas both from NIS' domestic sources and from Srbijagas's imports. The global economic crisis in 2009 however prompted some significant takeovers by Srbijagas or the state.[17] For exam-

[17] "Srbijagas: Gas, staklo, pilići...", B92, December 14, 2010, accessed on January 18, 2018 at https://www.b92.net/biz/vesti/srbija.php?yyyy=2010&mm=12&dd=14&nav_id=479101

ple, Azotara Fertilizer Plant, Petrohemija and Smederevo Steel Mill, which are not owned by Srbijagas or the state, amassed huge losses from 2008 to 2014 despite receiving cheaper natural gas from Srbijagas.[18] It is in the strategic interest of Gazprom for all three companies to survive since they constitute almost one third of Serbia's gas market. Gazprom may avoids purchasing these companies outright, and instead leverage their debt to pressure Serbia since the indebted companies' potential collapse could leave thousands of workers on the street protesting.

By participating in the Serbian energy sector through buy-ups, it appears that Gazprom has positioned itself to potentially benefit from Serbia's gas debt vulnerability by cutting gas deliveries to Serbia. The most significant reduction in gas supply – by 30 percent – occurred just days before a visit by Russian president Vladimir Putin to Belgrade in 2014. At the time, Gazprom stated that the official reason for the gas cut was Srbijagas' debt to the Russian company.[19] In March 2016, Srbijagas began talks on restructuring its total debt of around EUR 1 billion – close to half of which is owed to Russian state-owned banks. Ultimately, the Serbian state took over the majority of the debt owed directly to Gazprom, which has contributed to the country's worsening fiscal position. In June 2017, the Serbian energy minister reported that state-owned companies have fully repaid all gas debt worth USD 450 million to Gazprom.[20]

Russia's footprint in the gas sector extends through intermediary channels as well, such as Yugorosgaz, a joint venture between Srbijagas and Gazprom in which the Russian side controls 75 percent of the shares (see Fig. 4 above). The venture originally was set up to construct the gas interconnector with Bulgaria and to gasify southern Serbia, but in 2007, the company became the main intermediary in Srbijagas's gas trade with Russia. Yugorosgaz receives around a 4 percent premium on the gas it resells to Srbijagas, contributing to profits of approximately EUR 15 million in 2013 alone.[21]

Gazprom has designed the gas supply structure to its benefit – and apparently at the expense of Srbijagas. Gazprom sells the contracted volume to Yugorosgaz in Ukraine, then Srbijagas buys the same gas but at a 4 percent premium and pays the additional shipping costs through Hungary. For years, the paradox has been such that after Yugorosgaz sells the Russian gas to Srbijagas, the national gas supplier resells it at a low, regulated price back to Yugorosgaz for its own distribution in southern Serbia, which contributes to persistent large losses on Srbijagas' financial statements.

Although many elements of the gas trade between Serbia and Russia remain unknown due to the confidentiality of the contracts, investigative reports from leading Serbian media outlets[22] show that Srbijagas bears significant losses due to its gas trade arrangements. Eventually, the Serbian taxpayer will have to foot the bill, most likely through the issue of more public debt to be covered by higher taxes or a cut in social expenditures. Yugorosgaz, on the other hand, does not reinvest its proceeds into developing its gas pipeline system in Serbia or constructing the interconnector with Bulgaria as negotiated by the Russian and Serbian governments, but instead divides the funds between the company's owners.[23]

[18] Republic of Serbia – Fiscal Council. Assessment of State-Owned Enterprises in Serbia: Fiscal Aspects. Belgrade: July 31, 2014, accessed on 22 January, 2018 at http://www.fiskalnisavet.rs/doc/eng/analysis_of_state-owned_enterprises-fiscal_aspect.pdf

[19] "Russia Reduces Gas Flow to Serbia over Unpaid Debt," *Novinite.com*, November 1, 2014, http://www.novinite.com/articles/164467/Russia+Reduces+Gas+Flow+to+Serbia+over+Unpaid+Debt

[20] Ralev, Radomir (2017). "Serbia owes no gas debt to Russia – energy min Antic," SeeNews, June 5, 2017, accessed on January 2, 2018 at https://seenews.com/news/serbia-owes-no-gas-debt-to-russia-energy-min-antic-571092#sthash.Oamnx7Hb.dpuf

[21] Originally, the Bulgarian-Serbian interconnector was believed to be a pipeline to transport Russian gas in the future.

[22] E.g. Insider, TV B92.

[23] Apart from 100 km of pipeline built down to Nis before 2000, there has been very little progress in construction of the gas pipeline Nis-Dimitrovgrad (Bulgaria). In 2014, when Russia's Gazprom said it would abandon South Stream, Bulgaria and Serbia, which had signed a memorandum for the construction of the gas interconnector in 2012, were forced to look for alternative gas supply options.

Srbijagas receives 25 percent of all proceeds, while the other 75 percent are transferred abroad, including 50 percent to Gazprom in Russia and 25 percent to another company, Centrex, which research shows is ultimately owned by Gazprom.

In response to criticism from the European Commission and amid the freezing of the South Stream project, Serbia began to restructure the gas sector at the end of 2014. According to the Energy Community Secretariat, the two transmission system operators (TSOs) licensed in the country – the state-owned Srbijagas and Yugorosgaz (distributing gas to the southern part of Serbia) – did not fulfil their obligation to effectively separate energy transmission from production and supply, as EU energy rules required. The respective reasoned opinion stated that although Yugorosgaz's ownership arranged the company into a separate pipeline subsidiary in fall 2012, it did not do enough to ensure discretionary independence from political interference within the company.[24] The Secretariat also found the failure to unbundle the two TSOs a key obstacle to the proper development of a competitive gas market in Serbia.

The Bulgaria-Serbia interconnector project (IBS) however lagged behind, due to constant opposition from Srbijagas's management to implementing the restructuring of this company. After strong pressure from the Energy Community and the EU, Srbijagas formally established two new companies, one tasked with gas transportation and the other with gas distribution. Through a government special decision in January 2017, these new companies were to receive a functional permit from the Ministry of the Economy, despite the fact that Serbia's energy regulator denied the license request since the whole process happened only on paper. Both companies had neither property nor employees. In its latest Implementation Report, the Energy Community reiterated its observation that Serbia has persistently failed to unbundle Srbijagas and noted that the gas market remains closed and highly concentrated.[25] In any case, the functional permit approval opens the door to the EBRD's financing of the Bulgaria-Serbia Interconnector, which was conditional on the restructuring of Srbijagas. Overall, Serbia has been dragging its feet in implementing changes to the energy regulation framework in accordance with the EU and Community, especially in the areas directly affecting the current Gazprom-controlled gas supply structure. The result has been a decade-long delay of a key interconnector with neighboring countries that could improve the diversity and security of supply.

In many cases, corporate governance issues plague these downstream companies and actively contradict the declared long-term interests of Serbia. The mismanagement of the price-setting formula – in which Russian-controlled companies sell expensive natural gas to the wholesale supplier, which then resells the fuel to final clients at subsidized tariffs ensured by the regulator – is the most critical example of such failure. Moreover, the gas intermediary has successfully lobbied to stymie the liberalization of the gas market and halt the unbundling of Srbijagas, ultimately delaying EU alignment. There are also indications that the Serbian government continues to meddle in Srbijagas' corporate governance, failing to separate its high-level management from involvement in the Russian-controlled gas supply intermediary, Yugorosgaz.

In the fuel market, the Russian-owned NIS-Gazprom Neft and Lukoil dominate the upstream, refining, wholesale and retail sectors. According to 2015 data, NIS owns 325 gas stations (24 percent of all gas stations in Serbia), while Lukoil has 148 (ten percent), making them the two biggest retailers in Serbia. In addition, NIS supplies 78 percent of the fuels sold by other competitive retail gas stations. This data suggests that Russian-owned firms have almost full control and monopoly over the fuels market, with more

[24] Energy Community (2014). "Secretariat submits a Reasoned Opinion against Serbia on its failure to comply with gas unbundling rules." Press Release of the Legal Department, February 24, 2014, accessed on January 2, 2018 at https://www.energy-community.org/news/Energy-Community-News/2014/02/24.html

[25] Energy Community (2017). Serbia Gas Chapter in the 2017 Annual Implementation Report. October 15, 2017.

than a third of the retail market, all upstream production, and most wholesale storage facilities. While crude oil prices fell by more than half in 2014, retail gasoline and diesel prices fell between 4.4 percent and 10.4 percent, far below the decline registered in European oil trading indices such as the Platt's Mediterranean Quote.[26]

Railways

Russia, as opposed to the EU, has not provided any development aid grants to Serbia. However, Moscow has leveraged other types of macroeconomic loans to accelerate large-scale infrastructure projects that potentially serve Russian strategic interests. For example, a 2008 agreement between the two countries allocated USD 800 million towards modernizing the country's railway infrastructure. Despite the conclusion of the agreement nearly a decade ago, the government only began utilizing the loan in 2014. The original intention was for full implementation by 2016. In 2016, Russia extended the deadline for the loan's full implementation to 2021. Meanwhile, Zorana Mihajlovic, now Serbia's Minister of Transportation and a government Vice President, claimed in early 2016 that the government had implemented about USD 700 million of the total 800 million from the loan. Russia included a condition in the agreement that the Russian state-owned railway company would be the primary contractor for the modernization project.[27] The loan's repayment period is 20 years at a 4.1 percent per annum interest rate. This is less favorable than the EU financial institutions' terms, which have been providing infrastructure loans in the region at an interest rate between 1 and 3 percent. Serbia decided to contract the Russian Railways International subsidiary "Zarubezhstroitekhnologiya" (Зарубежстройтехнология) as a main contractor for the coordination aspects of the project as well.

There are two main possible reasons for Russia's interest in the modernization of Serbian railway infrastructure. First, it would grant Russia an opportunity to provide state-owned companies with procurements abroad, and second, it would improve strategic connections between Belgrade and Montenegro's port of Bar, where Russia was interested in building a naval base. Montenegro however officially rejected this project at the end of 2013, due to its NATO aspirations. Interestingly, another major railway modernization project involved a stretch between Belgrade and Nis. Improving this infrastructure would better connect the Serbian capital with a Russian humanitarian center in the country's second-largest city, Nis. The U.S. has perceived the Russian humanitarian center as a potential pretext for the deployment of a strategic Russian military facility, which could be used, for example, for espionage activities in the Western Balkans.[28] Despite repeated Russian calls urging the Serbian authorities to grant the humanitarian center diplomatic status, Serbia has so far refrained from doing so.[29]

Finance

Although Russian presence in the financial, banking, and insurance sectors is quite limited, in the past ten years, two Russian state-owned banks opened branches in Serbia: Moskovska Banka, now part of the VTB group, which opened its first branch in 2008 as a greenfield investment, and the Russian state-owned Sberbank, which entered the market in 2012, by purchasing the banking arm of Volksbank

[26] *Извештај о секторској анализи тржишта трговине на велико и трговине на мало дериватима нафте у 2015. години*, Commission for the Protection of Competition of the Republic of Serbia, December 2016, p. 35, http://www.kzk.gov.rs/kzk/wp-content/uploads/2017/01/Izvestaj-o-sektorskoj-analizi-trzista-trgovine-na-veliko-i-trgovine-na-malo-derivatima-nafte-u-2015-godini.pdf

[27] It is planned that participation of Russian companies in the reconstruction of the railway infrastructure in Serbia will be 70 %, while participation of Serbian companies is supposed to be 30 %.

[28] Tanjug (2017). "US "concerned" by Russian humanitarian center in Serbia." 15 June, 2017 as reprinted by B92, accessed on 4 December, 2017 at http://www.b92.net/eng/news/world.php?yyyy=2017&mm=06&dd=15&nav_id=101553

[29] Tanjug (2017). "No need to give Russian Center diplomatic status." 17 July, 2017 as reprinted by B92, accessed on 4 December, 2017 at http://www.b92.net/eng/news/politics.php?yyyy=2017&mm=07&dd=17&nav_id=101829

International in Central and Eastern Europe. Another small domestic institution, the Marfin bank, was recently taken over by the Czech Expobank, owned by a Russian businessman, Igor Vladimirovich Kim; there is some anecdotal evidence of Kim's links with President Putin.[30] However, none of these banks is on the list of 10 major banks that hold more than 77 percent of the banking market in Serbia. The three Russian-owned banks jointly hold 4.7 percent of Serbia's market, and only Sberbank is visibly trying to establish itself in the marketplace. In addition, there is only one Russian-owned insurance company, Sogaz, founded jointly by Srbijagas and Sogaz Insurance from Russia. Nevertheless, Agrokor's recent default on a Sberbank loan could provide Russia with an opportunity to expand its political footprint in the region. The potential failure of Agrokor's subsidiaries in Serbia could also trigger larger unrest, given that hundreds of businesses serve and are dependent on Agrokor's supply chain.

In 2012, when Sberbank took over Volksbank's business in the region, the Russian financial institution expressed its readiness to invest EUR 100 million in Serbian export companies tied to the Russian market, as well as to help attract a strategic partner to purchase the Smederevo Steel Plant.[31] To date, Sberbank has not significantly increased its market share in Serbia, and maintains the relatively low profitability of its previous owner. In addition, the bank's initial plans to finance the acquisition of the Smederevo steel plant did not go beyond a formal agreement, and cooperation with companies exporting to Russia did not materialize in large numbers.[32] Sberbank has preserved the investment policy of its Austrian predecessor and has not gotten involved in developing business cooperation with the largest privately-owned companies in Serbia, since local businessmen own many of them.[33] Sberbank considers these businesses risky, as several banks in Serbia collapsed in the period 2008 – 2015, due supposedly to political meddling into their business. Sberbank, however, was interested in purchasing the Komercijalna Banka or Banka Intesa (a Serbian subsidiary of Italy's Banca Intesa) in late 2013, as the latter has been the biggest creditor of Srbijagas.[34] No agreement was reached though, and there have been no new developments in the past four years.

One notable exception has been Sberbank's aggressive investment in the retail sector, including the largest retailer in the Western Balkan region, the Croatian holding company Agrokor. The company, whose owner, Ivica Todoric, has been reported to have close ties to Croatia's government over the years, has functioned as a highly centralized and in many respects unreformed business. Relying heavily on bank loans, the company has expanded into almost all countries of the Western Balkan. In early 2017, Agrokor employed some 60,000 people throughout the region and had an income equal to roughly 15 percent of Croatian GDP. The company simultaneously accumulated large debts, totaling around USD 6.4 billion or six times its equity.[35] It owes around 18 percent of its debt to Sberbank, while VTB has provided around EUR 300 million in loans (5.4 percent of the total) (See Fig. 5). Sberbank also supported Agrokor's acquisition of a Slovenian retailer, Merkator, in 2014, which in turn owned the Serbian chain Roda. At the time of the Merkator buy-out by Agrokor, Western creditors were skeptical of the company's ability to finance the purchase. Sberbank was the only institution that backed the Croatian holding, providing it with a EUR 600 million loan, followed by a second EUR 400 million loan to improve the company's financial

[30] Bjelotomic, Snezana. "Marfin Bank: Putin's man Igor Kim gets green light for takeover." Serbianmonitor.com. 30 November, 2016.

[31] "Sberbanka traži partnera za Železaru Smederevo," RT Vojvodina website, August 23, 2012, http://rtv.rs/sr_ci/ekonomija/sberbanka-trazi-partnera-za-zelezaru-smederevo_338100.html

[32] Interview with the source close to Sberbank Serbia August 7, 2017.

[33] Ibid.

[34] "Rusi žele Komercijalnu banku?," B92, November 25, 2013, http://www.b92.net/biz/vesti/srbija.php?yyyy=2013&mm=11&dd=25&nav_id=781821

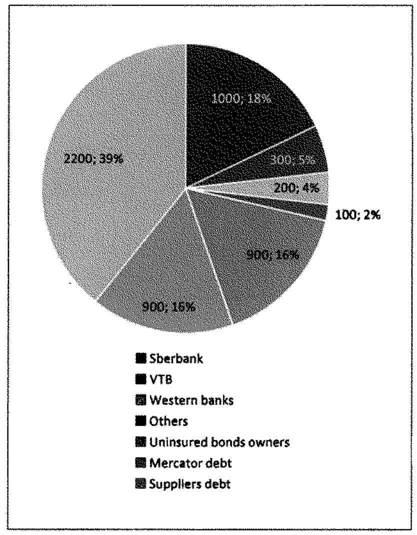
[35] Ilic, Igor. "Croatia passes law to protect economy from Agrokor-like crisis," Reuters, April 6, 2017.

health. Agrokor used the shares of some of its major subsidiaries to secure the second loan, including the Croatia-based PIK Vinkovci, Ledo, Zvijezda, and Jamnica.

Despite ballooning debt and unsustainable growth, Agrokor remained relatively stable until February 2017, when Russian Ambassador to Croatia Anvar Azimov threatened that Agrokor "will have to repay the loans from Russia and Russian banks or will face the consequences."[36] He added that the company had financial problems and that this time Russian banks would not come to its rescue. The statement sent shockwaves through the market. In the following days, credit agencies downgraded Agrokor's long-term debt rating, which led to a stampede of creditors asking for the repayment of their loans. Sberbank later clarified that the bank was not interested in acquiring the Agrokor businesses but only in improving the holding's management.[37]

In an attempt to consolidate Agrokor, in March 2017, Sberbank gathered four other creditors (Privredna banka Zagreb, Reifeisen banka Austrija, VTB Banka Austrija AG, and Zagrebacka banka) and issued one large syndicated loan with the condition that Agrokor appoint new management, consisting of independent experts. At the same time, Croatia adopted a special law that would restructure the management of companies with systemic importance for the economy (later dubbed "Lex Agrokor"), with the immediate purpose of stabilizing Agrokor. This law effectively prevented a potential Sberbank takeover of Agrokor. The law imposes compulsory state administration for companies with more than 5,000 employees and debt levels higher than EUR 1 billion, depending on the company's loan agreement. The Slovenian parliament similarly introduced "Lex Mercator" to protect the use of the Slovenian subsidiary of Agrokor to cover Agrokor's debt. Croatia installed a special administration in early 2017 to run the company for the following 15 months. The new management succeeded in persuading a American Knighthead Capital Management (AKCM) fund specializing in distressed companies to secure a EUR 480 million loan to Agrokor. Sberbank rejected the deal and proceeded to claim its Serbian and Bosnian assets that had been used as securities for its loan to Agrokor. However, the Serbian Commercial Court did not allow Lex Agrokor to apply to the subsidiaries in Serbia. Consequently, Sberbank was able to begin a lawsuit claiming its Serbian assets as loan guarantees in July/August 2017. The Serbian court decided to rule against Lex Agrokor in order to protect Serbian companies from potential bankruptcy during a resale.

Figure 5. Structure of Agrokor's Debt by Source (EUR million and share %)



Source: CSD calculations based on an analysis by Bloomberg.

[36] "Rusija više neće davati kredite Agrokoru – Hrvatski koncern moraće da vrati pozajmljeni novac," E-Kapija, February 11, 2017, http://www.ekapija.com/news/1669550/rusija-vise-nece-davati-kredite-agrokoru-hrvatski-koncern-morace-da-vrati-pozajmljeni

[37] "Vučić pred susret s Putinom: Sberbank preuzima 52 % udjela u Agrokoru," SEEbiz, March 26, 2017, http://www.seebiz.eu/vucic-pred-susret-s-putinom-sberbank-preuzima-52-udjela-u-agrokoru/ar-153125/

Clearly, the Agrokor's crisis has the potential to critically affect the Serbian economy. In Serbia, Agrokor owns a supermarket chain (made up of three brands), a retail credit card company, pastry and ice cream companies, a mineral water and sunflower oil producer, real estate management companies, and various consultancies. Agrokor directly employs 11,200 workers, or 16 percent of all employees of Russian-controlled or –related companies in the country.[38] Merkator-S, which is the second biggest retailer in Serbia with around EUR 867 million in revenues in 2016, has 350 diverse supermarkets under its purview, making it one of the largest companies in Serbia in terms of turnover and employees. The company works with at least 660 domestic suppliers with enormous significance for small-town economies.

Not surprisingly, Serbia pledged to prevent companies under Agrokor's ownership from suffering any direct damage and announced, in April 2017, that it would introduce temporary measures in commercial courts to protect these companies.[39] Following this statement, Sberbank filed multiple requests in Serbian commercial courts to block the disposition of companies' property related to Agrokor. Serbian law prevents a foreign-owned parent company from guaranteeing loans with the property of subsidiaries in Serbia. This effectively supported the Sberbank request. The courts introduced additional temporary measures that the forbid creditors of Agrokor companies from expatriating affected Serbian property.

During the Agrokor crisis, the Serbian mainstream media however reported that several businesspeople who could be connected to Russia were interested in taking over the ailing subsidiaries in Serbia.[40] Rodoljub Draskovic, who is a brother-in-law of Danica Draskovic, a current member of the Board of Directors of NIS, is one of the most prominent among them. Because Sberbank has indicated that it would not like to run the Agrokor subsidiary businesses itself, it is possible that the Russian financial institution will sell them to private owners. So far, the Serbian government and the courts have assisted Sberbank in its fight for control of Agrokor's assets. By allowing asset transfers into the hands of companies with ties to Russia, Moscow could potentially penetrate deeper into the Serbian economy. The extensive reach of Mercator-S into the Serbian economy could represent a future vulnerability.

Political Amplifiers

Dating back to at least the 19th century, Serbia has traditionally perceived Russia as a strong ally in its political ambitions. The Kremlin's support for Serbia's cause in Kosovo and Russia's rejection of Kosovo's independence have strengthened the image of Russia as a guardian of Serbia's interests. While domestic Russian media outlets have promoted a shared vision of international relations in the Western Balkans, a network of dedicated Russian institutions in Serbia has fostered feelings of proximity. The network has been expanding in recent years to provide support (including financial aid) to organizations and groups that promote Russian interests. Branches of Russkiy Mir (Russian World) and a representative office of the International Fund for the Unity of Orthodox Nations have operated in Novi Sad and Belgrade since 2005. Attempts to strengthen mutual ties between Serbia and Russia have further intensified since 2013, the same year that the Council of the EU announced Serbia's readiness to start accession talks. At the same time, the Russian Institute of Strategic Research (RISI) established a local branch in Belgrade, its only one in the Western Balkans. RISI's website states that the institute is a major scientific, research and analytical center

[38] "Seratlić poručio Ljajiću: Mercator S plaća sve na vreme," SEEbiz, 23 March, 2017, http://rs.seebiz.eu/seratlic-porucio-ljajicu-mercator-s-placa-sve-na-vreme/ar-152959/

[39] "Vučić o Agrokoru: Evo šta možemo da uradimo," Mondo, 19 April, 2017, http://mondo.rs/a1000962/Info/Ekonomija/Agrokor-Vucic-i-ministri-iz-regiona-zasedaju.html

[40] BIZLife (2017). "Rodoljub Draskovic offering Todoric to take over Agrokor's operations in Serbia." Reprinted in online media portal Ekapija on 27 April, 2017, accessed on 2 January, 2017 at https://www.ekapija.com/en/news/1742166/rodoljub-draskovic-offering-todoric-to-take-over-agrokors-operations-in-serbia

founded by Russia's President, with the primary goal of providing information to the presidential administration and other state institutions. There are also several other Russian foundations, including the Gorchakov Public Diplomacy Fund, the Strategic Culture Foundation, the Center of National Glory, and the Foundation of St. Andrew, which have promoted Russian interests through various activities: financing projects on Serbia's neutrality,[41] organizing roundtables and conferences on Russian soft power,[42] and helping to establish Russian centers in Serbia's academic institutions.[43] Several Serbian political parties, including parties that participate in the current government, claimed cooperation with Russia's ruling party, United Russia.[44]

Russia has promoted the creation of several Serbian-language branches of major Russian media outlets, often with a comprehensive section devoted to political affairs. Since 2012, a considerable number of online news outlets that openly promote Russian interests in Serbia, by focusing on Russian military strength[45] and spreading fear of U.S. influence, have appeared.[46] The first among them was the web portal Vostok (www.vostok.rs). There is a considerable number of web news portals that have appeared since 2012 that openly advocate Russian interests in Serbia. Among the most influential are Novi Standard (www.standard.rs), Srbin.info (www.srbin.info), Vaseljenska TV (www.vaseljenska.com), but also smaller portals such as Gazeta (www.vesti-gazeta.com), Fakti (www.fakti.org) Kremlin (www.kremlin.rs), Glas Moskve (www.glasmoskve.rs) etc. Additionally, the state-owned news agency Sputnik opened a regional editorial office in Belgrade in 2015. In Serbia, Sputnik operates in the Serbian language through its internet portal and radio program, providing to local radio stations free content, which is widely used. One of the major Serbian weeklies, Nedeljnik, contains the R Magazin supplement, published by Rossiyskaya Gazeta as part of a project "Russia Beyond the Headlines." Public perception is that the promotion of Russian interests is visible even in the most prominent daily tabloids, such as Informer[47] and Srpski telegraf. Efforts to penetrate almost all areas of public life are also obvious from Gazprom's donation of USD 5 million to the Serbian Orthodox Church, which was spent on drawing mosaics in the St. Sava Church. This project is part of Gazprom's comprehensive program for projects in the fields of culture and the preservation of the historical heritage of Serbia.[48]

The activities of Russian organizations and their Serbian media counterparts fall into several thematic areas. First, these outlets promote a Russian perspective on international affairs, for example, saying that the current crisis in Ukraine will be more dramatic because of U.S. involvement,[49] or they interpret history through a Russian lens in the spirit of support for the long-term Russian-Serbian alliance. Secondly,

[41] NSP (2015). News about project on Serbia's military neutrality. October 17, 2017, accessed on December 25, 2017 at http://slobodarski.rs/2015/10/17/fondacija-dostojanstvo-i-fond-gorcakov-dogovorili-zajednicku-konferenciju-o-aktivnoj-neutralnosti/

[42] NSPM (2014). Round table on Russian soft power. November 15, 2017, accessed on December 25, 2017 at http://www.nspm.rs/politicki-zivot/meka-moc-rusije-u-srbiji-mogucnosti-i-perspektive.html?alphabet=l

[43] Sputnik (2017). Opening of the Russian centre on the Faculty of Political science in Belgrade. December 16, 2016, accessed on December 26, 2017 at https://rs.sputniknews.com/drustvo/201612161109269463-Centar-za-ruske-studije-FPN1/

[44] Danas (2016). Who are the allies of Putin's party in Serbia?. December 26, 2017, http://www.danas.rs/danasrs/politika/ko_su_saveznici_putinove_partije_u_srbiji.56.html?news_id=321319

[45] Sputnik (2017). Recent news about new Russian basis in Syria. December 26, 2017, https://rs.sputniknews.com/rusija/201712261113946517-rusija-stalna-grupa-sirija-baze/

[46] Sputnik (2017). Recent news about US influence in Serbia 2018. December 26, 2017, https://rs.sputniknews.com/komentari/201712251113943563-na-nisanu-lazanskog/

[47] Informer (2017). News about new weapons for Serbia as a gift from Russia. December 21, 2017, accessed on December 26, 2017 at http://informer.rs/vesti/srbija/361738/samo-u-informeru-putin-se-dogovorio-sa-vucicem-vi-cutite-a-mi-saljemo-oruzje

[48] Blic (2017). Company "Gasprom Neft" with 4 million euros finances a mosaic in the Temple of Saint Sava. April 22, 2016, accessed on December 6, 2017 at http://www.blic.rs/vesti/drustvo/poceli-radovi-kompanija-gasprom-njeft-sa-4-miliona-evra-finansira-mozaik-u-hramu/ltwy1yz

[49] Sputnik (2017). Recent news, allegedly, about US military activities in Ukraine. December 26, 2017, https://rs.sputniknews.com/rusija/201712261113945545-karasin-ukrajina-isporuka-oruzje-donbas/

they attempt to discredit Western structures (NATO, the EU) by claiming that these institutions counter Serbia's interests (for example, EU support for Vojvodina's "separatist groups")[50] and that they pose a threat to global peace and stability. Thirdly, they present Russia as Serbia's closest ally, whose actions are always consistent with the interests of Serbia.[51] They emphasize common aspects of Serbian and Russian history, in particular the tradition of fighting shoulder-to-shoulder in the two world wars. Next, they criticize the pro-European actions and present Serbia as a country repeatedly humiliated by the EU, as well as by the U.S., yet still "determined" to become a part of the Union to the detriment of the Serbian society.[52] Finally, Russian media constantly remind of past disputes and conflicts between Serbia and its Balkan neighbors, which seems to aims to deter Serbia's EU integration and the process of reconciliation in the region.[53]

Governance Vulnerabilities

To bolster its foothold in the Serbian economy, Russia appears to systematically target Serbia's governance deficits. Russia strategically invests in the energy sector, often with the effect of reducing competition, reinforcing its position, and locking in supply. These investments promote Russia's economic and political interests and foster interdependence. To achieve these ends, Russia seems to identify and use weaknesses in Serbia's regulatory regimes and corporate governance. Gazprom has successfully struck deals in secrecy and without transparent cost/benefit analyses, which has locked Srbijagas into a number of long-term contracts, as in the case of the South Stream project. The management of the South Stream project did not comply with the principles of competitive and transparent public procurement, and involved unaccountable spending. A joint-venture company, in which Gazprom controlled 51 percent of shares, was to oversee the management of the project. This venture company was also in violation of the Third Energy Package, part of the energy obligations that Serbia has committed to implement. Seven years later, Srbijagas still has not fully restructured to comply with European energy rules. Domestic opposition to the restructuring is most likely related to the high likelihood that unless the contract with Gazprom changes significantly to the benefit of Serbia, if Srbijagas loses its transmission and gas storage operations and becomes just a distribution company, it might go bankrupt. Moreover, Gazprom might have opposed the restructuring, since it would bring more competition to a highly concentrated and closed market, potentially endangering its market share in Serbia.

Similarly, Gazprom has opposed indirectly the construction of the Serbia-Bulgaria Interconnector, which could bring down gas prices by diversifying the source and type of gas imported into the country. Yugorosgaz, the Gazprom-Srbijagas joint venture, was mandated to implement the project, but did not have an interest in actually constructing the interconnector. Constructing it would have directly challenged Gazprom's dominant supply position on the Serbian market. In addition, the key condition for EBRD to finance the construction was the requirement for Srbijagas to restructure its company. Ultimately, its failure to restructure, largely hindered by Serbian officials close to Gazprom, was the final blow to any hope for construction of the interconnector.

It also appears that preserving Bajatovic as the CEO of Srbijagas coincides with Gazprom's interest

[50] Vesti.rs (2015). Allegedly, EU and NATO are planing to make new state – Vojvodina. February 16, 2015, accessed on December 25, 2017 at https://www.vesti.rs/Evropska-Unija/DA-LI-JE-VOJVODINA-NOVA-INSTANT-DRZAVA-NA-BALKANU.html

[51] Srbin info (2017). News on strengthing ties between Russia and Serbia through military cooperation. December 16, 2017, accessed on December 25, 2017 at http://srbin.info/2017/12/17/putin-definitivno-salje-srbiji-s-300/?lang=lat

[52] Sputnik (2017). News about US blackmail on Serbia. December 23, 2017, accessed on December 26, 2017 at https://rs.sputniknews.com/politika/201712231113918663-Hojt-li-nova-ucena/

[53] Srbin info (2017). News about possibility for Dayton 2 which allegedly means disappaerence for Republika Srpska (as a part of Bosna and Herzegovina). December 23, 2017, accessed on December 26, 2017 at http://srbin.info/2017/12/26/sta-se-krije-iza-projekta-dejton-2-pandorina-kutija/

in ensuring that the Serbian gas supplier remains a state-owned entity. Bajatovic's party, SPS, holds an important position in Serbia's government, as one of the partners in the ruling coalition. Such close proximity between business, particularly related to state-owned enterprises, and politics creates the potential for conflict of interest. Since the state has acted as the guarantor of the company's gas debts (which other Srbijagas-supplied companies have further exacerbated with their debts), Gazprom's ties to Bajatovic have secured, in essence, a guaranteed stream of revenues from the Serbian state.[54]

Moreover, Gazprom has installed an enormously profitable intermediary between itself and Srbijagas. This intermediary, Yugorosgaz, makes a commission on the resale of Gazprom gas to Srbijagas. Bajatovic, CEO of Srbijagas and a member of the Board of Directors of the Gazprom-controlled intermediary, Yugorosgaz, has also been the Serbian representative in most joint ventures with Gazprom, including South Stream, Sogaz, and Banatski Dvor, the underground gas storage facility. His appointments to the senior management of these companies would appear to contradict the OECD's best practices in corporate governance, which recommend clear separation between politics and the management of national companies, in order to prevent conflicts of interest, clientelism, and unprofessionalism.[55] From his positions, Bajatovic receives around EUR 20,000 per month,[56] which is 20 times more than his baseline reported income from Srbijagas. Because of Srbijagas' sponsorship, he is also the President of the Board of Directors of the Sport Society Vojvodina, an association of sport clubs from Novi Sad, and was a member of the Board of Directors of one of two biggest football clubs in Serbia, Crvena Zvezda, whose main sponsor is Gazprom.

The Anti-Corruption Agency recommended in 2014 that Bajatovic resign from the post of CEO, but he managed to defy the recommendation.[57] In the media, he often promotes cooperation with Russia in the energy sector and criticizes all other energy diversification options, including the interconnector with Bulgaria and any potential supply from a liquefied natural gas terminal on Krk in Croatia.[58] By objecting to the restructuring of Srbijagas, he has thwarted progress on the interconnector project, because the EBRD demanded Serbia's alignment with the Third Energy Package, which requires that the ownership of supply and transmission activities be legally and functionally separated. He has also readily defended Gazprom's interests in the media, and has publically opposed, among other issues, an attempt to increase the mining tax.

Concerning oil and fuels, Gazprom and Lukoil have completely taken over the wholesale market. They currently control also more than a third of the retail segment. The result has been higher fuel prices, lack of competition, and significant influence over the country's economy through the indirect control of a large share of value-added tax and excise tax revenues.[59] Gazprom's below-market-price purchase of the controlling stake in NIS has raised serious ques-

[54] SHADOW GOVERNANCE INTEL. (2017). "Can New Blood Shake Up Serbia's Power Industry?" OilPrice.com, August 5, 2017, accessed on January 2, 2018 at https://oilprice.com/Energy/Energy-General/Can-New-Blood-Shake-Up-Serbias-Power-Industry.html

[55] OECD. (2015). OECD Guidelines on Corporate Governance of State-Owned Enterprises. Edition 2015, accessible and downloadable at http://www.oecd.org/corporate/guidelines-corporate-governance-SOEs.html

[56] Nataša Latković "Srbijagas" u sve većoj dubiozi, a Bajatoviću VEĆA PLATA za čak 1.400 evra," February 2, 2017, *Blic*, accessed on November 29, 2017 at http://www.blic.rs/vesti/politika/srbijagas-u-sve-vecoj-dubiozi-a-bajatovicu-veca-plata-za-cak-1400-evra/s2brymd

[57] "Agencija: Bajatović će moći usmeno da se izjasni o predloženoj smeni," November 25, 2015, *Blic*, accessed on December 21, 2017 at http://www.blic.rs/vesti/politika/agencija-bajatovic-ce-moci-usmeno-da-se-izjasni-o-predlozenoj-smeni/2fqzqbb

[58] "Srbija u problemu – nema alternative za ruski gas," March 26, 2015, *Sputnik Srbija*, accessed on December 21, 2017 at https://rs-lat.sputniknews.com/ekonomija/20150326893419/

[59] Serbia's then Prime Minister Vucic said during a meeting with CEO of NIS on 23 October, 2017 that NIS was the top contributor to the Serbian budget with EUR 1.3 billion by the end of 2017, close to 15 % of the country's 2017 budget revenues and 16 % of the government spending (2.5-3 % of GDP). According to our estimates, Lukoil contributes additional 4-5 % to the total budget revenues. For the quote of ucic see http://www.b92.net/eng/news/business.php?yyyy=2017&mm=10&dd=23&nav_id=102621

tions and led to some allegations of corruption.[60] The total value of NIS, according to the preliminary estimates of privatization advisors in 2006, was between EUR 1.2 and 1.6 billion. In other words, 51 percent of NIS was worth EUR 612-816 million (excluding the value of the domestic oil reserves). Interestingly, the Agreement and its associated protocol set the purchasing price for the controlling stake in the NIS at EUR 400 million, with the obligation that Gazprom would finance a modernization program worth EUR 500 million. Gazprom then borrowed funds to fulfill its obligation instead of using its own equity. By raising debt instead of using equity, Gazprom committed NIS to repay the loan with interest. In addition, the Agreement granted Gazprom favorable terms for the extraction of oil and gas in Serbia. It set NIS's mining tax at 3 percent (lower than 7 percent tax for other companies, and far below the international practice of between 15 and 30 percent), and exempted NIS from future tax increases until the company becomes viable. Considering Gazprom's massive modernization project and ongoing oil and gas explorations, such terms may mean that that the Serbian state has decided to forego a great amount of potential future revenue. Most Serbian energy officials claim that the mining tax for NIS should remain the same until the Agreement's expiration in 2038. In 2009, the Serbian Constitutional Court upheld the constitutionality of the bilateral Agreement.[61] The Russian company's favorable mining tax treatment and its excessively privileged position on the market are amongst the most contentious points of the deal.[62]

The privatization of Beopetrol by Lukoil in 2003 also raised concerns about Russian involvement. According to the privatization agreement, Lukoil pledged to invest USD 106.8 million in the company's infrastructure. In a September 2013 report on Beopetrol's privatization, the Serbian Anti-Corruption Council said that Lukoil never honored the agreement, causing damage to the company equivalent to millions of U.S. dollars. According to the Council's report, instead of investing in Beopetrol's infrastructure, Lukoil violated the privatization arrangement by actually dipping into Beopetrol's funds to lend the parent company USD 120 million, or around 90 percent of what it had just paid to purchase this state-owned company. The Council claimed that Serbia's Agency for Privatization never really controlled the process and never prevented Lukoil from proceeding with the loan transfers.[63] Moreover, Lukoil's then head in Serbia, Srdjan Dabic, who was involved in the privatization, has been linked to a Belgrade mayor, Sinisa Mali (a close associate of Serbia's then Prime Minister, Aleksander Vucic), who bought 14 apartments on Black Sea coast from Dabic for USD 6.1 million in 2012.[64] Mali denied that he bought the apartments.[65]

[60] Even before his election, Alexander Vucic, criticised the corrupt nature of the agreement with Gazprom and the acquisition of NIS saying that a higher share of its profit should be transferred to the state budget, and the proceeds should be used to repay Srbijagas's debt to Gazprom. When Vucic became Serbia's Prime Minister, Serbia's prosecution opened an investigation into the 2008 deal. Media reported that the investigation was to pressure the Russian side to take over the petrochemical company, Petrohemija, which in 2014 owed around EUR 20 million to NIS for the fuel it was using for its production. The investigation was completed in 2016 but no indictment has ever been made.

[61] International and Security Affairs Centre – ISAC Fund and Law Office 'Nikolić, Kokanović, Otašević', (2009), "Pravna analiza aranžmana između Srbije i Susije u oblasti naftne i gasne privrede," December 21, 2009, p. 6, accessed on December 21, 2017 at https://www.isac-fund.org/download/Pravna%20Analiza%20Aranzmana%20Rusije%20i%20Srbije%20u%20oblasti%20Naftne%20i%20Gasne%20Privrede-FINAL.pdf

[62] The mining royalty for NIS (Gazprom) is 7 % of the revenue, while the company pays just 3 %. In many other oil and gas producing countries, the royalty is between 20 and 30 %.

SerbiaEnergy. (2017). "Serbia mining: According to experts, little chance to increase the mining royalty in Serbia." February 23, 2017.

[63] Dojčinović, Stevan, Peco Dragana and Tchobanov, Atanas. (2015). "The Mayor's Hidden Property". Organized Crime and Corruption Reporting Project. October 19, 2015, accessed on November 30, 2017 at https://www.occrp.org/mayorsstory/The-Mayors-Hidden-Property/index.html

[64] Ibid.

[65] "Mali: Nemam milione ni 24 stana, podneo sam prijave", 24 December 2015, *N1*, accessed on 21 December 2017 at http://rs.n1info.com/a120718/Vesti/Mali-Nemam-milione-ni-24-stana.html

Russia has also sought to mix politics and business to obtain preferential treatment in railway modernization. Since international agreements are exempt from Serbia's laws that govern public procurement contracts, Russian loan-based activities in the railway sector have not been organized transparently or based on competitive tenders. Instead, the agreement awarded project opportunities directly to Russian Railways, the former CEO of which, Vladimir Yakunin, is reportedly one of the closest associates of the Russian President. Most recently, in February 2017, Russian Railways announced that it would acquire a Serbian infrastructure maintenance company, which would further expand the company's control over the Serbian railway sector.[66] Serbia's inability to implement in a timely fashion the USD 800 million loan for railway modernization also potentially provided an opportunity for the Russian government to pressure Serbia on other issues.

Serbian's decision to back Sberbank during the Agrokor crisis shows that its independent institutions, including the courts, tend to follow executive policies. In handling the crisis, both Serbia and Sberbank have been determined to keep Agrokor's subsidiaries afloat. Sberbank has great exposure to the debt and the Serbian economy could face a severe shock. However, Serbia's current soft position provided an opportunity for Russian financial institutions to expand their economic presence in Serbia. While the negotiations are ongoing, Sberbank's prominent seat at the table means that, whatever the outcome, Russian-owned entities can take advantage of a crisis in Serbia. Sberbank's potential takeover of key assets would allow Russia to control a considerable part of the Serbian retail market.

Policy Recommendations

Several key policy recommendations include:

- Economic and investment agreements should be evaluated based on their business merits and should not be the result of geopolitical bargaining.
- Before concluding any long-term energy agreements or embarking on expensive infrastructure projects, the government should conduct a comprehensive cost-benefit analysis that takes into account security concerns, costs, and the flexibility of contractual obligations.
- Serbia should ensure that infrastructure projects funded by foreign governments are not exempt from EU and national laws on public procurement and transparency, and are in accordance with relevant international rules.
- Serbia's energy infrastructure projects should be in compliance with the country's obligations on the European level, including in the areas of ownership of gas transmission, supply, and production.
- Serbia should explore efforts to complete a natural gas interconnector with Bulgaria to allow for diversification of the gas supply.
- The Commission for Protection of Competition should prevent the concentration of ownership in strategic sectors, such as the oil and gas sector, and monitor possible market collusion that hinders competition and can lead to monopolies.
- There needs to be a clear separation of the management of state-owned energy companies and politics. The government's nominations of professional management should be considered by Parliament to ensure independence from external pressure.
- Serbia's government, in collaboration with Parliament, should introduce corporate governance standards that clearly separate politics from the day-to-day management of state-owned companies, and adopt competitive staffing procedures that would ensure individual accountability and transparency in decision-making.
- Serbia should eliminate or reduce subsidies for loss-generating enterprises, as well as household heating and gas prices, because they contribute to enormous debts that ultimately the increase citizens' tax burden.
- The government should end the inefficient practice of converting debts into equity. Serbia should take control of the wholesale gas supplier's distressed

[66] "Ruske železnice kupuju u Srbiji firmu koja održava pruge," 1 February 2017, *N1*, accessed on 21 December 2017 at http://rs.n1info.com/a225088/Biznis/Ruske-zeleznice-kupuju-firmu-u-Srbiji.html

subsidiaries and resell them to private investors through transparent privatizations. If Serbia cannot find buyers for these assets, the companies should be allowed to default.

- Serbia should not allow state-owned energy companies to be in charge of managing behemoth infrastructure projects. Instead, strategic private investors should carry the burden of financing and managing such projects, which would also make it more likely that only cost-effective infrastructure is built.
- Serbia should ensure that the sale of distressed companies and assets is transparent and should be careful about the potential concentration of capital in the hands of a small number of politically-connected businesses.
- The government should strengthen its financial intelligence institutions, such as the Administration for the Prevention of Money Laundering and the relevant unit in the Serbian Security Intelligence Agency, to closely monitor foreign transactions associated with large-scale merger and acquisition deals, in order to prevent the illicit transfer of funds and formation of opaque ownership structures in strategic sectors.
- Serbia's media and communications regulators, the Republic Broadcasting Agency and the Republic Telecommunications Agency, should investigate the ultimate beneficial ownership of media and alert counterintelligence in cases of foreign covert operations involving disinformation campaigns in the country.
- The private sector and civil society should be more engaged in advocacy, relevant decision-making and monitoring processes to close the abovementioned gaps.
- Civil society organizations and investigative journalists should focus more on shedding light on corrupt practices in public procurement, privatization procedures and intergovernmental negotiations of major economic deals.
- The media should play a critical role in objectively informing (even educating) the public about how strategic economic sectors, such as energy, function, in order to debunk existing misconceptions and expose decisions that harm Serbia's public interest. In this respect, the government should ensure that media outlets operate in a safe environment and are granted full access to public data and information.

CENTER FOR
THE STUDY OF
DEMOCRACY

ASSESSING RUSSIA'S ECONOMIC FOOTPRINT IN BOSNIA AND HERZEGOVINA

Policy Brief No. 74, January 2018

Overview

Russia has been one of the key political players in Bosnia and Herzegovina since the Dayton Accords brought the 1992 – 1995 war to its end. According to the peace agreement, Bosnia and Herzegovina consists of two entities – the Federation of Bosnia and Herzegovina (FBiH) and Republika Srpska (RS) with roughly equal territories – and the Brcko District. It is in RS, the entity with a Serb majority, that Russia has gained the most traction. Russia has particularly backed RS's opposition to the Transatlantic integration of Bosnia and Herzegovina, as well as RS secession initiatives.[1] Many regional observers feel that the secessionist aspirations of RS could potentially lead to a new regional conflict.

Russia holds a permanent seat on the Peace Implementation Council (PIC) and the Steering Group of the PIC, thus guiding the work of the High Representative in Bosnia and Herzegovina involved in interpreting the Dayton Peace Accords. In addition, the leadership of the RS has developed its own independent foreign policy vis-à-vis Russia, including the establishment of a quasi-diplomatic mission in

[1] Knezevic, Gordana (2016). "Russia's Fingers in Bosnia's Pie," Radio Free Europe. 28 September, 2016.

This report was compiled using publicly available sources and databases. CSD would like to thank Dr. Dimitar Bechev, Research Fellow, Center for Slavic, Eurasian, and East European Studies, University of North Carolina at Chapel Hill and Ilya Zaslavsky, Research Expert, Free Russia Foundation and Academy Associate at Chatham House, for providing valuable comments.

KEY POINTS

- Most of Russia's economic footprint in Bosnia and Herzegovina is concentrated in Republika Srpska. Russia has consistently been the largest foreign investor in the entity and the fourth largest in Bosnia and Herzegovina, with around EUR 547 million of foreign direct investment (FDI) in the country over the 2005 – 2016 period.
- The revenues of Russian enterprises in RS make up 42 % of the total revenue of all foreign companies in the entity, while the combined turnover of EU-based firms is only 27 %. Russia's corporate footprint in the country as a whole grew more than twice over the past decade, from 2.6 % in 2006 to around 5.7 % in 2015 in an otherwise shrinking economy.
- Bosnia and Herzegovina is completely dependent on Russian gas supplies. Russian companies also control the country's two refineries, both located in Republika Srpska.
- Russia has backed the Republika Srpska leadership in its increasingly antagonistic relationship with the FBiH and the central government.

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Russia outside Bosnia's official diplomatic representation in 2006.[2] The President of RS, Milorad Dodik, has used Russia's support to preserve his political credibility in the eyes of the RS electorate and to gain significant leverage in decision-making on the state level.

In exchange for the political support of RS, Russia has reciprocated economically via a number of economic interventions. Most of Russia's economic footprint in Bosnia and Herzegovina is concentrated in RS. Russia has consistently been the largest foreign investor in the entity and the fourth largest in Bosnia and Herzegovina, with around EUR 547 million of foreign direct investment (FDI) in the country over the 2005 – 2016 period.[3] The revenues of Russian enterprises in RS make up 42 % of the total revenue of all foreign companies in the entity, while the combined turnover of EU-based firms is only 27 %.[4] Russia's corporate footprint in the entity is concentrated in only five companies, which are all in the energy, banking, and pharmaceutical sectors, making up a significant part of the regional economy's value-added.

Similarly to many countries in Central and Eastern Europe, Russia's economic footprint is channeled primarily through the oil and gas sectors. Bosnia and Herzegovina is completely dependent on Russian gas supplies. Although the country imports oil not only from Russia but also from Croatia and Serbia, Russian companies control the country's two refineries, both located in RS. Russia has been exerting significant pressure on Bosnia and Herzegovina utilizing the short-term nature of its gas supply agreement (the contract is renegotiated every year), gas debts of local central heating plants, and one of the highest gas import prices in Europe charged by Gazprom. In addition, a Russian pipeline project, South Stream,[5] dominated the energy policy agenda of the government for years, derailing Bosnia and Herzegovina from pursuing alternatives for diversification of supply via Croatian liquefied natural gas (LNG) or a planned Ionian-Adriatic Pipeline (IAP), which would connect the country to the Trans-Adriatic Pipeline (TAP) and, thus, to Caspian and Middle Eastern gas.

Foreign investment deals, privatization tenders, and many other intergovernmental economic agreements with Russia have been marred by allegations of high-level corruption and money laundering operations, primarily, it is claimed, to sustain a powerful group around President Dodik. Through financial support to the leadership in Banja Luka, the capital of RS, Russia has increased its ability to influence the entity's institutions. This, in turn, has bottlenecked decision-making processes at the central level and delayed the country's progress in making reforms needed to pursue a Euro-Atlantic path. Additionally, Russia has backed the RS leadership in its increasingly antagonistic relationship with FBiH and the state government. A vivid example was Russia's support for a September 2016 referendum organized by the RS leadership on the recognition of a controversial national day for RS. Russia has sought to amplify secessionist sentiments in RS, thus stirring tensions in Bosnia and Herzegovina, which could pull the whole Western Balkans away from integration into the Euro-Atlantic institutions.

[2] RS also has trade representations in Washington, Brussels, Vienna and other cities around the world. The opening of separate trade offices has convinced the state government that RS is trying to pull away from the Federation, see Latal, Srecko (2009). "Republika Srpska EU Office Triggers Dispute," BalkanInsight. 13 February, 2009.

[3] CSD calculations based on an analysis of a commercial corporate database.

[4] According to the structural business statistics published in the statistical agency of RS accessed at http://www.rzs.rs.ba/front/category/28/?up_mi=12&left_mi=41&add=41

[5] A controversial project aiming to transport natural gas from Russia to Southeast and Central Europe via Black Sea, from Serbia to RS.

Russia's Economic Footprint in Bosnia and Herzegovina[6]

Russia's economic footprint in Bosnia and Herzegovina is among the largest in Southeast Europe, trailing only Montenegro, Bulgaria, and Serbia. Russia's corporate footprint, in terms of revenue controlled by Russian entities, grew more than twice over the past decade, from 2.6 % in 2006 to around 5.7 % in 2015 in an otherwise shrinking economy. In absolute figures, Russian companies had a turnover of around EUR 1 billion in 2016. However, looking at RS alone, Russia plays a much more significant role. In 2014, Russian companies made up close to 39 % of entity's total foreign-controlled revenues, while EU-based companies had only a 33 % share.[7] This is a reflection of the fact that EU-based companies are wary of investing in RS for a range of reasons, including because of potential corruption-related costs. The share of Russian companies in the entity's economy reached more than 8 % in 2014, as Russians filled the gap following the withdrawal of some Western investors, in part due to the poor rule of law and economic stagnation.

Russia's FDI increased from USD 235 million[8] in 2008 to around USD 547 million in 2016, which made up 8.1 % of the country's total FDI and 3.3 % of gross domestic product (GDP). Most Russian investment is concentrated in oil processing, fuel and gas distribution, and financial services. This, however, does not include purported direct government loans from Russia to RS. The President of RS was reported to have negotiated a EUR 270 million loan from Moscow in April 2014, in an attempt to push the state government to abandon a previous agreement with the International Monetary Fund (IMF). It implied that structural reforms[9] were impossible to implement due to a lack of political consensus among the political parties.[10] Months later, President Dodik said that Russia had pledged between EUR 500 and 700 million, which would cover the government's expenditures in case the IMF did not disburse a new loan following the expiration of the Fund's lending agreement in 2015.[11] There were, however, no reports confirming the actual disbursement of these Russian funds.

In October 2015, President Dodik discussed a USD 300 million loan to finance the entity's budget deficits in 2015 and 2016 from a California-based investment fund called Global Bancorp Commodities and Investments, Inc. (GBCI), implementing waste management technologies in Russia. According to several media sources, this company is also linked to a Russian citizen – Alexander Vassilev.[12] The loan negotiations with Russia came only a few months after the country was hit with devastating floods that paralyzed the economy and left the authorities with little cash to continue their operations. Again, no reports ever confirmed that this loan materialized. The terms of the potential loans also remained confidential, not only to the public but also to relevant government institutions, as these loans were not discussed in public or in RS Parliament.

Apart from three large mergers and acquisitions in the oil, banking, and pharmaceutical sectors, Russia and Bosnia and Herzegovina do not have close economic relations. Their trade turnover is marginal

6 In quantifying the Russian economic footprint, the analysis derived from available data of national statistics on bilateral trade and foreign direct investment (FDI) stocks. For calculating the corporate footprint, the study utilized a commercial corporate database, which contains information on ultimate beneficial ownership and financial information on companies in Bosnia and Herzegovina, allowing the authors to identify all Russian-owned companies active in the country. The data on the Russian companies' revenues was cross-checked with statistics of the entities' statistical agencies. To quantify the Russian economic footprint, the authors compared imports and Russian FDI to GDP, and the revenues of Russian-owned and indirectly-controlled companies in Bosnia and Herzegovina to the country's total revenues in the economy.

7 According to structural business statistics from a 2016 statistical yearbook of the RS.

8 FDI statistics before 2008 were not available.

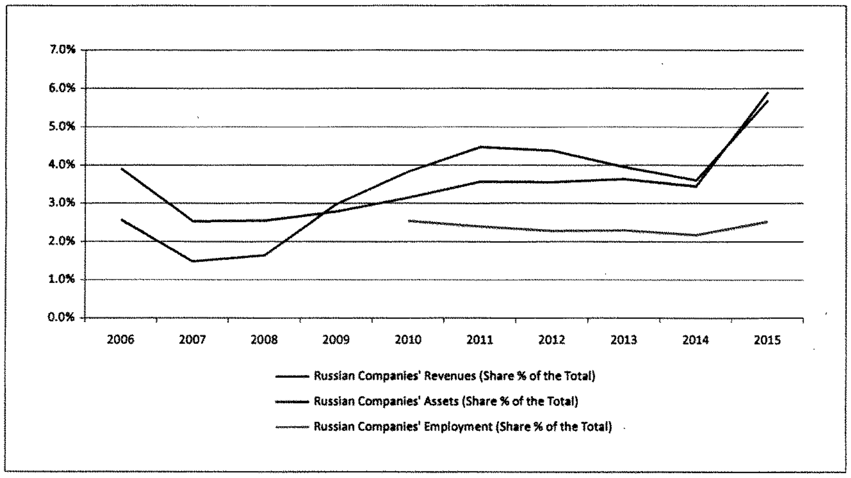
9 Latal, Srecko (2016). "Bosnia Clinches New €550m Deal With IMF," BalkanInsight. 25 May, 2016.

10 Jukic, Elvira (2014). "Bosnian Serbs Seek Russian Loan to Replace IMF," BalkanInsight, 3 April, 2014.

11 "Bosnian Serb leader says Russia will loan region 500-700 mln euros," Reuters. 19 September, 2014.

12 Mukova, Denitsa (2015). "Mystery investor lends $300mn to Republika Srpska," 16 October, 2015.

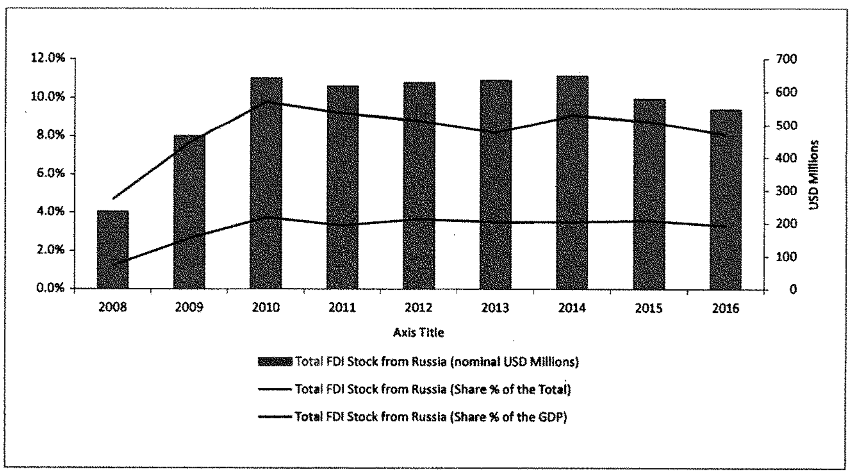
Figure 1. Russia's Corporate Footprint*



* *Data for employment in Russia-owned companies is missing for the years 2006, 2007, 2008, and 2009 due to the lack of national or international statistics.*

Source: *CSD calculations based on analysis of a commercial corporate database, using ultimate beneficial ownership as research criteria.*

Figure 2. Stock of Russian Foreign Direct Investment



Source: *CSD calculations based on data from the Central Bank of Bosnia and Herzegovina and the United Nations Conference on Trade and Development (UNCTAD).*

compared to Bosnia's overall trade, and the country's trade with the EU. In 2016, Bosnia and Herzegovina imported close to USD 5.775 billion from the EU – more than 20 times more than from Russia. However, Bosnia and Herzegovina is running a significant bilateral trade deficit with Russia, which in 2016 was over USD 250 million, or 3 % of GDP. Russia has never been among Bosnia's top 10 trading partners, and most of the trade deficit is due to the country's oil and gas imports, which have halved since 2013 due to falling energy prices. Exports to Russia began rapidly increasing since 2014, albeit from a low base, from USD 39 million in 2013 to USD 55 million in 2016. This is thanks to the expanded export of agricultural products to Russia following the embargo on EU goods.

The concentration of a deficit in the energy sector is an acute risk for a country heavily dependent on Russian energy. The role of oil and gas dependence in relations with Russia is even more significant because of the engagement between Moscow and RS President Dodik, and the RS's role in these economic sectors. The precarious situation of the country's finances, coupled with the fact that state-owned energy companies are conducting business with Russia, magnifies the potential risk that the trade deficit poses to the country's national security. This report analyzes how Russian capital has expanded its presence in some of the most strategic sectors of the country's economy, while exploiting governance gaps on the part of the administrations of the various entities of Bosnia and Herzegovina.

Vulnerable Sectors

Energy

The Bosnian electricity sector is quite diversified, and the country is among the biggest power exporters in the region. According to 2015 data from the International Energy Agency,[13] close to 64 % of the country's power is produced by burning domestic and imported coal; the rest comes from its abundant hydropower reservoirs.[14]

In the natural gas sector, though, the country is fully dependent on Russian imports. Natural gas covers around 25 % of the needs of the central heating utilities (the rest comes from fuel oil), but is otherwise insignificant for the country's energy sector. In 2015, natural gas made up only around 4 % of the total final energy consumption, and in absolute numbers, has not gone beyond 220 million cubic meters per annum. Despite the limited use of natural gas in Bosnia and Herzegovina, Russia has sought to take advantage of the country's import dependence to exacerbate divisions between the country's entities. Typical examples of this, as described below, are the management of the South Stream pipeline project and the resolution of a gas debt dispute.

Crude oil derivatives play a bigger role in the energy sector because they are used not only in transportation but also in central heating. Russia is not the only supplier of oil and oil products to Bosnia and Herzegovina. Croatia has also exported final oil products directly to the retail market in Bosnia and Herzegovina. However, the Bosnian refineries, all located in RS, are controlled by Russia's Optima Group, which imports only Russian crude via a pipeline from Serbia. Gazprom's NIS, registered in Serbia, is also one of the biggest fuel distributors in the country, together with Lukoil's Bulgarian branch.

Natural Gas

Bosnia and Herzegovina does not have any domestic natural gas production and is entirely dependent on Russian imports coming from one route, from Ukraine through Hungary and Serbia. It was one of the countries in Southeast Europe worst hit by a cut in Russian gas transit through Ukraine during a dispute between Gazprom and Naftogaz in 2009, when 50 % of the contracted gas supply to the country was interrupt-

[13] IEA (2017). Bosnia and Herzegovina: Balances for 2015, https://www.iea.org/statistics/statisticssearch/report/?country=BOSNIAHERZ&product=balances&year=2015

[14] International Energy Agency – Country Statistics: Energy Balances – 2015.

ed.[15] Authority over the regulation and management of the gas sector is vested in the two entities, which have constantly obstructed necessary cooperation on possible joint projects. State-owned BH Gas and Russian-controlled Energoinvest LTD (both supplying gas to FBiH), and the RS-based, Serbian-owned GAS RES have separate contracts with Gazprom. The contracts with Gazprom are renewed on an annual basis, while the gas transit agreements with Hungary and Serbia are for 10 years, and will expire at the end of 2018 and 2017, respectively.[16] Bosnia and Herzegovina paid the second-highest gas import price in 2013 at USD 515/1,000 cubic meters, trailing only Macedonia at USD 564.[17] The gas contracts of the two entities with Gazprom, similar to deals in most of the countries of Central and Eastern Europe, are linked to the price of crude oil, which has fallen precipitously over the past three years, alleviating the pressure on gas suppliers in Bosnia and Herzegovina. Yet, the relationship with Gazprom remains largely asymmetrical, in which the Russian supplier often uses its monopoly position to play the two entities against each other.

For example, in February 2015, the head of RS's GAS RES gas supplier and the CEO of Gazprom signed a new agreement for direct gas supply to the entity, bypassing one of FBiH's gas suppliers – namely BH Gas – at preferential pricing terms, after talks between the CEO of Gazprom and President Dodik in September 2014.[18] The contract stipulated that Gazprom would deliver 106 million cubic meters of gas to RS from July 1, 2015, to December 31, 2016.[19] The agreement was tied to a newly created joint company (60 % for Gazprom and 40 % for the RS), as compared to 51 % to 49 % in Serbia and 50 % and 50 % in Bulgaria, to construct an offshoot of South Stream from RS to FBiH. The state government was not consulted on this issue at all, though. Although energy sector governance is within the competencies of each entity, RS, due to its geographic advantage thanks to its proximity to Serbia's infrastructure, has yielded significant power over the gas supply to FBiH.

The leverage that Russia has gained over Bosnian gas policy and its implications for the country's energy security is probably most visible in the management of the country's section of South Stream. Both FBiH and RS expected that South Stream would resolve their problems with gas shortages due to bottlenecks on the existing pipeline network caused by disputes between the two entities. The goal of the RS leadership was to construct 280 km of gas pipelines to the capital of the entity, Banja Luka, and 46 residential areas in the RS. This is in an RS gasification plan dating to 2002. That is when the company Slavija International from Laktasi, Dodik's birthplace and a stronghold of his Alliance of Independent Social Democrats (SNSD), **was awarded a concession contract for construction of a 480 km-long gas pipeline along the Sava river.[20] South Stream would follow exactly the same route with a capacity of between 1.5 bcm/yr to 1.7 bcm/yr. In concluding the South Stream agreement, the RS however circumvented FBiH and the state government, effectively blocking any access to the planned pipeline beyond the RS-operated gas distribution network. According to RS estimates, direct and indirect losses for Bosnia and Herzegovina from the cancellation of South Stream exceeded EUR 2 billion.[21]**

[15] Ralchev, Stefan (2009). "Russian Gas Supplies to Bosnia Cut by Half." See News, 6 January, 2009, accessed on 13 November, 2017 at https://seenews.com/news/update-2-russian-gas-supplies-to-bosnia-cut-by-half-239252

[16] European Energy Community (2017). Annual Implementation Report. 1 September, 2017, Energy Community Secretariat.

[17] Gazprom's Grip: Russia's Leverage Over Europe. RadioFreeEurope – Infographics on the Russian gas dependence in Europe by country, accessed on 9 November, 2017 at https://www.rferl.org/a/gazprom-russia-gas-leverage-europe/25441983.html

[18] Posaner Josh (2014). "Gazprom's gas deal in Republika Srpska provides South Stream stop-gap," LSEE Southeast Europe Research Blog, 16 September, 2014, accessed on 13 November, 2017 at http://blogs.lse.ac.uk/lsee/2014/09/16/gazproms-gas-deal-in-republika-srpska-provides-south-stream-stop-gap/

[19] Gazprom Export Press Release, 27 February, 2015 accessed on 13 November, 2017 at http://www.gazpromexport.ru/en/presscenter/press/1531/

[20] Pavlova, Iskra. (2002). Serbian, Russian Firms Eye Gas Pipeline Construction in Bosnia – Media. SeeNews. October 19, 2009, accessed on 28 January, 2018 at https://seenews.com/news/serbian-russian-firms-eye-gas-pipeline-construction-in-bosnia-media-251148#sthash.PfRhLH7q.dpuf

[21] Article of Deutsche Welle of 4 December, 2014: http://www.dw.com/hr/i-bih-ostala-bez-milijunskih-investicija/a-18109661

On the part of FBiH, Gazprom concluded supply contracts with BH Gas and Energoinvest on an annual basis, with the latest valid until the end of 2017. BH Gas is the single wholesale supplier and one of two gas system operators in the entity (the other one is Gas Promet). In RS, there is another gas transmission operator, Sarajevogas Istocno Sarajevo. Between FBiH and RS, there is only one connection with a domestic transmission system at Zvornik, located in RS. Constant ethnic political infighting and the fact that there are three different transmission operators have contributed to the system's underperformance and supply shortages.[22] The fact that there are two different gas sector laws and regulations for transmission system operators means that gas suppliers face significant difficulties in shipping gas from one entity to the other, as capacity booking rules differ and limited cooperation between operators means that physical gas bottlenecks often halt the gas supply.

Internal squabbles between the two entities and among the many layers of authority in the gas sector have aided Russia's efforts to prevent gas diversification projects, including a link to Croatia that would provide FBiH's access to future LNG, Croatian domestic gas, and potential Azeri supply via the IAP.[23] In August 2016, the Minister of Foreign Trade and Economic Relations of Bosnia and Herzegovina, Mirko Sarovic, signed a Memorandum of Understanding (MoU) with his Montenegrin, Albanian, and Croatian counterparts on the construction of the IAP, which stipulated that the pipeline would pass through the Neum corridor on the Adriatic coast on FBiH's territory.[24]

Russia has pursued different strategies vis-à-vis FBiH and RS, which can be explained by its geopolitical priorities. Another example of RS's preferential treatment by Gazprom is an agreement signed with Russia in 2017. According to this agreement, GAS RES is not obliged to participate in a repayment of the USD 98 million gas debt accumulated by Bosnia and Herzegovina for gas supplies from Russia during the 1992 – 1995 war, and only BH Gas from FBiH should be responsible.[25] In May 2017, Russia sought through official means full repayment of the debt, following a March 2017 deal between Bosnia and Herzegovina and Russia on the settlement of the USD 125.2 million outstanding debt of the USSR to Socialist Yugoslavia.[26] FBiH was to receive 58 %, or USD 72.6 million, from the debt; RS – 29 % or USD 36.3 million; the Bosnian state institutions – USD 10 % or 12.5 million; and the Brcko district – 3 % or USD 3.8 million.[27]

Bosnia and Herzegovina was the last of the states of the former Yugoslavia to resolve its debt dispute with Russia, doing so only in 2017. Additionally, Bosnia and Herzegovina was the only Balkan country to receive its post-Yugoslav share of the clearance of the Russian debt in cash. The BH Gas company complained that the settlement of the gas debt issue was purposefully mismanaged to the benefit of RS.[28]

As a consequence of the redistribution of the debt burden entirely to FBiH, the financial situation of BH Gas has become precarious, which may potentially endanger Sarajevo's supply in the winter of 2017-18. After receiving the cash reimbursement from Moscow, it still owes Gazprom USD 25.4 million. FBiH has also expressed concerns that the RS could use

[22] European Energy Community (2017). Annual Implementation Report. 1 September, 2017, Energy Community Secretariat.

[23] Anastasios Giamouridis and Sprios Paleoyannis. "Security of Gas Supply in South Eastern Europe," The Oxford Institute for Energy Studies. July 2011.

[24] Pavlic, Vedran (2016). "Ministers Sign Memorandum of Understanding on Ionian-Adriatic Gas Pipeline," CroatiaNews. 27 August, 2016, accessed on 1 December, 2017 at https://www.total-croatia-news.com/item/13806-ministers-sign-memorandum-of-understanding-on-the-ionian-adriatic-gas-pipeline

[25] Garaca, Maja (2017). "Russia seeks repayment of $98 mln gas debt from Bosnia," 16 May, 2017, accessed on 13 November, 2017 at https://seenews.com/news/russia-seeks-repayment-of-98-mln-gas-debt-from-bosnia-report-568868#sthash.WBIIPSFD.dpuf

[26] Garaca, Maja (2017). "Bosnia's BH Gas confirms Russia seeks repayment of gas debt," 18 May 18, 2017, accessed on 13 November, 2017 at https://seenews.com/news/bosnias-bh-gas-confirms-russia-seeks-repayment-of-gas-debt-569151

[27] Ibid.

[28] Ibid.

its geographic position as a transit region for the gas pipeline via Zvornik, in RS, and cut the gas supply to FBiH under pressure from Gazprom. RS has already cooperated with the Russian supplier to circumvent FBiH in the South Stream negotiations and disrupt the construction of new pipelines to alternative sources of gas. The full control of the natural gas supply to the whole territory of Bosnia and Herzegovina by the RS would create a risk for gas consumers in FBiH, which accounts for half of the total gas demand in the country.

Furthermore, RS has worked to prevent the opening of a new gas supply route to FBiH from Croatia, so that RS can maintain its monopoly over supply to FBiH. To achieve this, RS has limited the scope and size of a low-pressure gas pipeline that is planned to be built exclusively for the needs of the Oil Refinery in Brod (a company privatized with Russian capital in a deal brokered by RS authorities). For full-scale gas diversification in FBiH to succeed, there is a need for a high-pressure gas pipeline such as the previously proposed Brod-Zenica interconnector from Croatia (the North-South pipeline). This gas pipeline built by BH-Gas and financed by the European Bank for Reconstruction and Development (EBRD) would have provided not only FBiH but the whole country with access to an alternative source of supply. The North-South pipeline would also diminish the use of fuel oil for heat generation in district heating plants across the country, a major source of pollution.

RS has always objected to a North-South pipeline project,[29] instead proposing the Sava pipeline (also known as the East-West pipeline), which would also reach the Croatian border shipping Russian gas. Sava was conceived by Gazprom and the Serbian gas supplier, Srbijagas, in 2002, but did not advance. The project appears to be dead, especially after the cancellation of South Stream, which would have supplied Sava with Russian gas. For now, only the North-South pipeline can potentially be revived if RS does not continue to sabotage the project.

Another associated problem with small pipeline projects such as Sava and North-South in the Balkans is the lack of investment interest in a small gas market with poor prospects for significant expansion. Despite this fact, Gazprom has continued to develop new concepts for expanded gas supply to RS, most recently in mid-December 2017, when the Russian company and RS signed an agreement on a 70 million EUR liquefied gas plant in Zvornik. This is at a border crossing point where RS receives its Russian gas supplies from Serbian territory.[30] The new project could be interpreted as an attempt to replace South Stream.

Croatia and FBiH took steps to revive the North-South pipeline in 2017. In April, Plinacro (a Croatian Gas Company) and BH Gas agreed to cooperate in connecting a gas transmission network through Croatia and Bosnia and Herzegovina through a EUR 80 million, 160-km pipeline, so that FBiH could be connected to a planned Krk LNG terminal on the Adriatic coast.[31] The gas pipeline would, according to this agreement, connect Zagvozd, Imotski, Posusje, and Travnik/Novi Travnik. Adding this alternative would help Bosnia and Herzegovina fulfil the requirements of the Energy Community, according to which the country must have more than three sources of gas supply.[32] The planned new pipeline network connecting Bosnia and Herzegovina and Croatia represent a part of the Energy Community initiative to complete a Gas Ring within the Western Balkans, which would connect to the IAP pipeline along the Adriatic coast and eventually to TAP in Albania. Although RS would also benefit

[29] Pavlic, Vedran (2017). "Bosnian Serbs Reject Croatian Gas," 5 March, 2017, accessed on 13 November, 2017 at https://www.total-croatia-news.com/business/17230-bosnian-serbs-reject-croatian-gas

[30] JutarnjiVijesti (2017). "Milorad Dodik Signs a Milestone Agreement with Gazprom," 16 December, 2017, accessed on 5 January, 2018 at https://www.jutarnji.hr/vijesti/svijet/milorad-dodik-s-gazpromom-potpisao-ugovor-za-milijunsku-investiciju-ruski-plinski-div-u-republici-srpskoj-gradit-ce-tvornicu-ukapljenog-plina/6850335/

[31] "Bosnia, Croatia: New cross border gas pipeline," SEE Energy News, 18 May, 2017, accessed on 14 November, 2017 at https://serbia-energy.eu/bosnia-croatia-new-cross-border-gas-pipeline/

[32] The Energy Community ensures the implementation of the EU energy acquis in the member-countries. The Regulation Concerning Measures to Safeguard Security of Gas Supply (994/2010/EU) stipulating the three-sources rule is part of the acquis.

from receiving diversified gas supplies, the entity decided to focus on Russia-led gas pipelines originating in Serbia instead.

In general, the lack of gas demand makes it difficult to justify the large investment costs. It has been difficult for Bosnia and Herzegovina to reconcile the importance of diversification for the security of supply with its limited economic viability. Demand has been low because gasification rates are among the lowest in the region, and household gasification has not been attractive due to high prices caused by inefficiency and regulatory fragmentation.

Oil Sector

Russia's engagement in the oil sector of Bosnia and Herzegovina dates back to the privatization of two of RS's oil refineries, Rafinerija Nafte Brod and the Modrica motor oil processing facility, in 2007. They were privatized by a newly-created company, Neftengazinkor, for a total of EUR 125.8 million, far below the initial price of EUR 285 million through a process which widely judged non-transparent.[33] Neftegazinkor is 100 % owned by the Russian state-owned oil company Zarubezhneft, which took a loan from a Russian state-owned development bank to buy the two refineries.[34] Russian officials described the project as both politically and economically part of a broader strategy for strengthening alliances with countries of the Western Balkans.[35] The refineries and the fuel distribution business contribute up to 25 % of the RS budget revenues, making them the largest taxpayer in the country. In 2011, Optima Group, as Zarubezhneft in Bosnia and Herzegovina is known, was also responsible for 19 % of Bosnia and Herzegovina's GDP, according to a statement in the company's annual report.[36] There have been some press reports that Optima Group may have engaged in tax evasion worth more than EUR 5.8 million, and even that it has not repaid RS in full for the refineries and the gasoline stations.[37] Zarubezhneft also acquired an 80 % share in a wholesale and retail fuels supplier, Nestro Petrol, which has become the largest gas station chain in Bosnia and Herzegovina. Nestro Petrol operates 87 fuel stations and controls more than a quarter of the market in RS, according to its 2012 annual report.[38]

Optima Group controls roughly 35 % of Bosnia and Herzegovina's wholesale fuels market (down from 60 % in 2011), which is a 6 % decline year-on-year due to increasing competition from Croatia's INA and the entry of smaller traders, including the Russian-owned, Serbia-based NIS, with a 7 % share of the market.[39] Optima also sells around one-fourth of its output abroad, to maximize profits from higher-price markets in Croatia and Serbia. On average, the Brod refinery has produced between 850,000 tons and 1 million tons of fuel derivatives in the past five years, with a steady decline in output in the past three years due to more competition on the wholesale market from Croatian suppliers.

The Modrica motor oil refinery, the third major company in Optima Group, is the only such facility of its kind in the country, producing 220 types of products, and is among the 10 largest in Europe. The plant has experienced a significant decline in oil distillate refining, with volume falling from 70,000 tons in 2013 to a little over 40,000 tons in 2016, due to diminishing demand and low profit margins.

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[33] BalkanInsight (2008). Russia-owned Bosnian Oil Refinery Reopens. 27 November, 2008, accessed on 5 January at http://www.balkaninsight.com/en/article/russia-owned-bosnian-oil-refinery-reopens

[34] Sito-Sucic (2009). "Bosnian refinery reopening shows Russia's hand," The New York Times, 6 January, 2009, accessed on 15 November, 2017 at http://www.nytimes.com/2009/01/06/business/worldbusiness/06iht-bosoil.4.19127279.html

[35] Ibid.

[36] 2011 Annual Report of Zarubezhneft. This figure significantly exceeds the Russian corporate footprint as analyzed by the turnover method, which estimates the share of the Russian companies' turnover from the total turnover of the economy.

[37] Čigoja, Marina (2016). Exclusively: Russians have evaded millions of stamps in the Oil Refinery. Capital.ba, 5 August, 2016, accessed on 5 January, 2018 at http://www.capital.ba/ekskluzivno-rusi-utajili-milione-maraka-poreza-u-rafineriji-nafte/

[38] 2012 Annual Report of Zarubezhneft.

[39] 2016 Annual Report of Zarubezhneft. Back in 2011, the company controlled close to half of the whole market.

Again, the privatization of the two refineries was conducted without a tender and without any public debate.[40] It was completed quickly, possibly to rescue three bankrupt state-owned companies with debts of over EUR 72 million. Zarubezhneft pledged to pay off the arrears and invest an additional EUR 600 to 700 million in modernizing the facilities.[41] An independent audit by Deloitte in 2015 showed that Optima Group was facing a severe debt crisis, with short-term debts exceeding assets by EUR 20 million (the company's total debt was over EUR 320 million in 2016), and that a number of suspicious transactions had been conducted by the holding's management.[42] These transactions were alleged by opposition leaders and some experts as potential sources for money laundering operations by the leadership of the RS as well as to channel Russian political support.[43] Another theory is that Russia threatened to cut the crude oil supply to the Brod refinery unless it came under the ownership of a Russian company.[44]

RS did not enforce the refineries sale's conditions, which included investments in the modernization of the facilities. By 2016, Optima Group invested barely EUR 120 million in modernizing the production facilities and raising the output capacity of the refineries (representing six times less than the initial pledge of at least EUR 675 million).[45] Since then there have been a number of high-level meetings involving the management of Zarubezhneft and President Dodik, during which it was reported that the Russians promised millions in further investment. Most recently, in June 2017, Zarubezhneft announced its construction plans for a low-pressure gas pipeline from the Brod refinery to Croatia that would alleviate the high levels of air pollution in both Croatia and RS's Brod valley.[46] The announcement came less than a month after a meeting of the foreign ministers of Russia and Croatia on the pollution issue in Slavonski Brod. BH Gas objected to this construction project, claiming that it would block an alternative gas interconnector from Bosnia to Croatia supplying both entities, as well as the Brod refinery.[47]

The accumulation of a debt of around EUR 300 million by the Brod refinery has also affected its production levels and has prompted its management to begin selling some non-essential assets. According to one of the leaders of the People's Democratic Movement (NDP), Dragan Cavic, this is not consistent with the privatization contract.[48] The auditing company KPMG stated in a 2016 report that Optima Group would not survive without a bailout from the parent company.[49] Continued negative financial results have however not prompted the sale of the whole business, and some experts claim that Optima Group

[40] "Russia-owned Bosnian Oil Refinery Reopens," BalkanInsight, 27 November, 2008, accessed on 15 November, 2017 at http://www.balkaninsight.com/en/article/russia-owned-bosnian-oil-refinery-reopens

[41] Ibid.

[42] Panic, Katarina (2015). "Ailing Bosnian Oil Firm Flogs Assets to Raise Cash," BalkanInsight, 26 June, 2015.

[43] Ibid.

[44] RWR Advisory Group (2016). Economic and Financial (E&F) Threat Assessment for Bosnia and Herzegovina: Assessing the Activities of Russian State-Owned Enterprises in Bosnia and Herzegovina. RWR, 4 March, 2016.

[45] Optima Group website page accessed on 15 November at http://optimagrupa.net/en/o-nama/

Pavlova, Iskra. (2010). Bosnian Oil Refinery Bosanski Brod To Absorb 103 Mln Euro in Investment in 2010 – Media. SeeNews. March 22, 2010, accessed on 25 January, 2018 at https://seenews.com/news/bosnian-oil-refinery-bosanski-brod-to-absorb-103-mln-euro-in-investment-in-2010-media-194596#sthash.w4q3YfNy.dpuf

[46] See Energy News (2017). "Zarubezhneft interested in the construction of low-pressure BiH-Croatia gas connection," See Energy News, 14 June, 2017.

[47] Ibid.

[48] Panic, Katarina. (2015). Ailing Bosnian Oil Firm Flogs Assets to Raise Cash. Balkan Insight. 26 June, 2015, accessed on 25 January, 2018, at http://www.balkaninsight.com/en/article/russian-owned-bosnian-serb-oil-industry-struggles-for-survival

[49] Garac, Maja (2017). "Future of Bosnian oil refinery Brod uncertain without aid from Russian parent", SeeNews, 11 April, 2017, accessed on 15 November at https://seenews.com/news/future-of-bosnian-oil-refinery-brod-uncertain-without-aid-from-russian-parent-kpmg-564876#sthash.x7isivaW.dpuf

has preserved its position in the country for political reasons.[50]

Non-transparent and non-competitive privatization processes have been used systematically to acquire strategic assets in the region. In a similar fashion, Russia has acquired oil, gas, minerals, and manufacturing assets in Serbia, Bulgaria, Macedonia, and Montenegro. These agreements often undervalue the assets, and the new owners often fail to implement agreed-upon investment plans, while managing the companies into losses and decapitalization. There is often also a substantial indirect effect on the states themselves, as these large loss-making companies typically do not pay corporate taxes and fail to create new jobs, which can generate fiscal and socio-economic vulnerabilities.

Oil Exploration and Production

Russia has also been interested in expanding its upstream activities in the Western Balkans since GazpromNeft purchased NIS, a Serbian oil and gas giant, in 2009. The company has aggressively expanded into the wholesale and retail fuel markets of Serbia, Romania, Bulgaria, and Bosnia and Herzegovina, currently operating 400 fuel stations in the region. In Bosnia and Herzegovina, NIS currently operates 37 gas stations, placing it among the top four largest retailers (11 % of the total fuels market) in the country.[51]

In 2011, RS granted a Zarubezhneft-NIS[52] joint venture, Jadran Naftagas, a 28-year exclusive concession for its oil and gas exploration and production on the entity's territory.[53] Jadran Naftagas had planned to invest USD 41 million in exploration during the first three years and 188 million for the next 25 years. So far, some oil reserves have been discovered in several places, which could potentially lead to an increase of Russia's economic presence in the country. As a consequence of lower prices that the Russian company may be able to afford to offer for its product, third parties could be eliminated from market competition.

Banking

While Russia's presence in the banking sector of Bosnia and Herzegovina is small compared to that of Italian and Austrian financial institutions (the four largest banks in the country are Austrian and Italian, with combined assets of more than EUR 5.6 billion), Sberbank has grown notably in the past five years.

Russia has entered the Bosnian market following the takeover of Austrian Volksbank by Russian state-owned Sberbank in 2012. Sberbank now controls all of the former Austrian bank branches in Central and Eastern Europe, including in Bosnia and Herzegovina, where it has 51 offices. According to an assessment of the banking sector by the IMF published in 2015,[54] Sberbank is the sixth-largest financial institution in the country by assets. It has around 100,000 clients and EUR 593 million of assets (5 % of total bank assets). In other words, this is almost twice its assets compared with 2012, when Sberbank entered the market.[55] Its loans and deposit portfolios have also been steadily rising, to around EUR 473 million and EUR 390 million in 2016. Sberbank's interests are primarily in corporate finance and energy projects.

[50] Djurdjevic, Maja (2016). "Russia's Political Interests Drive Investments in Bosnia," 4 July, 2016 accessed on 15 November, 2017 at http://www.balkaninsight.com/en/article/russia-s-political-interests-drive-investments-in-bosnia-06-30-2016
Panic, Katarina. (2015). Ailing Bosnian Oil Firm Flogs Assets to Raise Cash. Balkan Insight. 26 June, 2015, accessed on 25 January, 2018, at http://www.balkaninsight.com/en/article/russian-owned-bosnian-serb-oil-industry-struggles-for-survival

[51] NIS 2016 Annual Report.

[52] NIS is majority-owned by Gazprom.

[53] http://ir.nis.eu/en/news/single-news/jadran-naftagas-presented-preliminary-results-of-oil-and-gas-exploration-at-the-territory-of-the-republic-of-srpska/

[54] Report available on: https://www.imf.org/external/pubs/ft/scr/2015/cr15213.pdf

[55] 2016 Sberbank Bosnia & Herzegovina Annual Report, accessed at https://www.sberbank.ba/upload/docs/sb_en_online_ZOG.pdf

Sberbank is more active in RS, where it is the fourth-largest bank. It also services Optima Group and an energy company, EFT. EFT is owned by offshore companies in the UK that are reportedly under the ultimate control of a Serbian businessman, Vuk Hamovic. The UK Serious Fraud Office previously investigated Hamovic for international corruption related to the alleged rigging of electricity-trading deals and manipulation of foreign aid payments, though the case was dropped.[56] In 2014, Sberbank financed EFT's 21.2 million purchase of coal processing and transportation equipment for a Stanari coalmine. The mine was intended to supply coal to EFT's 300-MW Stanari thermal power plant, constructed with a 350 million EUR loan provided by the China Development Bank.[57]

The bankruptcy scandal of Agrokor has shown the growth of exposure to Sberbank's funding across the region. This Croatian retail giant, the owner of which, Ivica Todoric, has been reported to have close ties to the Croatian government, has operated as a highly centralised and unreformed fashion. Relying heavily on bank loans, the company has expanded into almost all of the countries of the Western Balkans. In the beginning of 2017, Agrokor had 60,000 employees throughout the region, with income around 15 % of Croatia's GDP. The company has simultaneously accumulated large debts of around USD 6.4 billion, or six times its equity.[58] Sberbank owns around 18 % of its debt, and VTB has provided around EUR 300 million in loans (5.4 % of the total). As Agrokor began defaulting on its debt, it was taken over by the Croatian state, which has tried to recover some of its assets in order to repay the holding's enormous debt.

The restructuring of Agrokor would necessarily have an effect on its Bosnian subsidiaries, including one of the largest retail chains, Konzum, which recorded revenue of EUR 434 million in 2015 and employed 4,154 people in Bosnia and Herzegovina. Agrokor has a total of eight subsidiaries in Bosnia and Herzegovina, with a total of over 5,000 employees.

Konzum's potential sale could have a domino effect of failing suppliers. It has more than 100 suppliers, including large meat and dairy plants.[59] Konzum owes them around EUR 66.5 million. So far, the suppliers have agreed to cooperate with Agrokor in a debt-restructuring program that started in September 2017.[60] In May 2017, Agrokor decided to put its Slovenian subsidiary, Mercator, in charge of the holding's business in Bosnia and Herzegovina, amid complaints by suppliers of not receiving regular payments for their deliveries.[61] The deal specifies that Mercator will take over 83 of 253 stores operated by Agrokor in the country.[62] Konzum also received a EUR 120 million injection from its fellow Agrokor subsidiaries in the country, which should be used to restructure the company's debts to suppliers.[63] Agrokor also agreed to restructure the EUR 34.6 million in claims of two other Agrokor sub-

[56] Leigh, David and Evans, Rob. "Fraud office drops Bosnia corruption case". The Guardian, 3 June, 2008.

[57] EFT (2014). "Loan Agreement for the Stanari Mine Signed Today", PR statement from the EFT website published on 16 April, 2014, accessed on 1 December, 2017 at http://www.eft-group.net/index.php/news/single/68/Loan-Agreement-for-the-Stanari-Mine-Signed-Today

[58] Ilic, Igor. "Croatia passes law to protect economy from Agrokor-like crisis," Reuters, 6 April, 2017.

[59] Among the biggest suppliers are the following companies: Coca Cola, AS Jelah Group, Atacco, Violeta, Orbico, Megamix, Milkos, Meggle, Akova, Perutnina Ptuj and Bimal Brcko.

[60] Pavlin, Vedran (2017). "Agrokor's Suppliers in Bosnia Ready to Continue Cooperation," Total Croatia News. 17 April, 2017, accessed on 1 December at https://www.total-croatia-news.com/business/18266-agrokor-s-suppliers-in-bosnia-ready-to-continue-cooperation

[61] Garaca, Maja (2017). "Croatia's Agrokor to focus on Bosnia due to problems with suppliers – receiver," SeeNews, 23 June, 2017, accessed on 1 December at https://seenews.com/news/croatias-agrokor-to-focus-on-bosnia-due-to-problems-with-suppliers-receiver-573396#sthash.dHX6xrKo.dpuf

[62] Garaca, Maja (2017). "Retailers Mercator, Konzum to operate side by side in Bosnia from August 1," SeeNews, 13 July, 2017, accessed on 1 December at https://seenews.com/news/retailers-mercator-konzum-to-operate-side-by-side-in-bosnia-from-august-1-575914#sthash.Q0dzM4Ow.dpuf

[63] Garaca, Maja (2017). "Croatian retailer Konzum's Bosnian unit eyes 15 mln euro capital injection – report," SeeNews, 15 August, 2017, accessed on 1 December at https://seenews.com/news/croatian-retailer-konzums-bosnian-unit-eyes-15-mln-euro-capital-injection-report-579744#sthash.4sEDnyv6.dpuf

sidiaries in Bosnia and Herzegovina, Ledo Čitluk and Sarajevski Kiseljak, into Konzum shares. Also, Konzum Sarajevo is set to receive a EUR 15 million loan from the main Agrokor holding.[64]

Apart from Sberbank, the only other bank with Russian ties operating in Bosnia and Herzegovina is MF Banka a.d. Banja Luka, formerly known as IEFK Bank. It opened its first branch in 2007, thus becoming the first Russian bank operating in the former Yugoslavia.[65] Prior to 2010, it was owned by the Russia-based East-European Finance Corporation, with a little significance for the country's banking sector.

Box 1. Case Study: Alleged Money Laundering and Questionable Offshore Investment in the Pharmaceutical Industry

A number of reports implicated Sberbank in the alleged facilitation of a suspected money laundering operation in 2012, which involved a majority share acquisition of Bosnia's largest pharmaceutical company, Bosnalijek,[66] by a Luxembourg-registered offshore fund, Haden.[67] Sberbank gave a EUR 4 million loan to Haden to finance the costs of purchasing Bosnalijek shares without reporting the operation to the Department for Combating Money Laundering and the Financing of Terrorism, and the Financial and Intelligence Department of the State Investigative and Protection Agency in Bosnia and Herzegovina (SIPA).[68] The bank supervision agency filed a criminal complaint against Sberbank for not disclosing the loan to Haden and the facilitation of another transfer of USD 5.76 million from Luxembourg to Haden's account in Sberbank's Sarajevo branch. Bosnia's prosecutor's office began an investigation into a possible money-laundering scheme, but after two years of proceedings, no indictments were filed against Sberbank. Some observers felt that the failure to file charges reflected a low level of capacity of investigators in Bosnia and Herzegovina to tackle complex cross-border cases.

Haden has also been associated in some reports with a large Russian pharmaceutical supplier, Imperia Pharma.[69] Haden purchased 52 % of Bosnalijek in two separate transactions through the Bosnian stock exchange for an estimated EUR 20 to 25 million.[70] Following the entry of Imperia Pharma into Bosnia and Herzegovina, Bosnalijek increased its share since 2013 in the Bosnian drug maker to over 50 %. Currently, Bosnalijek sells 150 products in 14 countries in Southeast Europe, Russia, and some former Soviet republics, with revenue of EUR 78 million, close to 90 % of which is generated in Russia.[71] This excessive dependence on the Russian market could prove to be a vulnerability for the largest Bosnian drug maker. For example, following Montenegro's acceptance into joining NATO and decision to align with the EU on sanctions, Russia banned its wine imports from the state-owned Plantaze plant, which had generated most of its sales in Russia.[72]

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[64] ESM (2017). "Agrokor To Recapitalise Konzum In Bosnia & Herzegovina," 4 September, 2017, accessed on 1 December, 2017 at https://www.esmmagazine.com/agrokor-recapitalise-konzum-bosnia-herzegovina/48608

[65] EMIS (2015). Mf Banka a.d. company report, accessed at https://www.emis.com/php/company-profile/BK/Mf_Banka_ad_2541530.html

[66] According to a 2013 IHS Markit study, Bosnalijek is the second largest pharmaceutical supplier in Bosnia and Herzegovina with around USD 21 million out of a USD 366 million market. The company's market position has improved significantly over the last couple of years as its revenues jumped to close to EUR 80 million after its entry into Russia and Turkey.

[67] Center for Investigative Reporting (2016). Fishy Transactions from Russia via Sberbank. CIN, 14 September, 2016.

[68] Ibid.

[69] "Luxembourg Haden increases its stake in Bosnia's largest drugmaker," Pharmaletter, 3 August, 2013.

[70] Ibid.

[71] "Bosnalijek to establish production of drugs in Russia," Pharmaletter, 7 July, 2017.

[72] Associated Press (2017). Montenegro says Russia banned its wine over NATO accession. 27 April, 2017, accessed on 5 January, 2018 at http://abcnews.go.com/amp/international/wireStory/montenegro-russia-banned-wine-nato-accession-47054642

Money laundering risks have long dogged the Bosnian banking system. SIPA previously raided several small banks in RS and arrested 10 financiers and bank regulatory officials, accusing them of colluding to facilitate corruption.[73] The affected banks were Bobar, Pavlovic, and Banka Srpske, among others. According to a report of the High Representative, Bobar bank's bankruptcy in 2014 (following the diversion of its funds) affected many public institutions, companies, and individuals.[74] The scandal also involved RS President Dodik, who was accused by Bosnia's Special Prosecutor of borrowing 750,000 EUR from Pavlovic Bank with a fictitious loan to purchase a luxurious villa in Belgrade.[75]

Political Interference

Russian companies have a significant footprint in several strategic sectors of the Bosnian economy, which has been amplified by the Kremlin's political influence in RS. Russia's support for RS President Dodik (e.g. for a September 2016 referendum on an RS national holiday) has fueled the entity's fierce opposition to the country's Transatlantic integration. Compounding this issue, an expansion-weary EU has not able to effectively capture the imagination of ordinary Bosnians, who have become disillusioned with the post-war transition, which in turn benefits local elites. Additionally, various soft power tools have been used by Kremlin proxies to foster popular appeal for Russia, which is often based on an exaggerated image of the importance of Russian investment in the country.

Bilateral high-level meetings between Russian and Bosnian officials have rarely amounted to anything more than grand promises of new investment with no real follow-up. RS's delegation to a business forum in Nizhny Novgorod in April 2016 aimed to expand trade and investment relations following Russia's embargo on EU agricultural goods. Of course, President Dodik also publicly endorsed the Crimean referendum and blocked Bosnia and Herzegovina from joining the EU's sanction regime against Russia.[76,77] However, the Russian Agricultural Inspection Agency banned the import of Bosnian fruits and vegetables in August 2016 for a period of three months, which dented some producers' optimism about entering the Russian market.

Despite promising Dodik hundreds of millions in loans to RS to close the entity's budget gap, there is no evidence that Kremlin ever disbursed any funds to the entity. The media hype created around multiple rounds of loan negotiations with Russia created the false impression that Russia plays an oversized economic role in Bosnia and Herzegovina, nurtured by Dodik himself. He has used this to strengthen his own image, portraying Russia as firmly standing behind his agenda. In an interview with Politico, Dodik said that unlike the EU and the U.S., Russia was not "asking him to do anything impossible" and was instead offering "economic cooperation."[78]

Meanwhile, even if the political in-fighting between the different ethnic groups in Bosnia and Herzegovina does not originate in Russia, Kremlin has sought to exploit and exacerbate existing tensions by inciting conflict over the country's gas supplies, the financing of pipelines, the provision of government loans, and even Bosnia's national holidays.

[73] Nuttall, Clare (2016). "Investigations reveal rotten side of Bosnian Republika Srpska's bank sector," BNE Intellinews, 13 May, 2016, accessed on 16 November at http://www.intellinews.com/investigations-reveal-rotten-side-of-bosnian-republika-srpska-s-bank-sector-97327/

[74] Ibid.

[75] OCCRP (2016). Bosnia and Herzegovina: Police Bust Bank Owner Linked to RS President Dodik. 13 February, 2016.

[76] Tanjug (2014). "Serbs won't let Bosnia join sanctions against Russia," 26 March, 2014, accessed on 11 December, 2017 via a copy of the article in B92 opened at http://www.b92.net/eng/news/region.php?yyyy=2014&mm=03&dd=26&nav_id=89781

[77] Bugajski, Janusz (2015). "Moscow Upholds Frozen Bosnian State," Center for European Policy Analysis, 3 August, 2015.

[78] Ibid.

Russia fully supported a September 25, 2016 referendum on to maintain January 9 as the national day of RS, which celebrates its founding during the war, despite a 2015 Constitutional Court ruling to ban this holiday on the grounds that it discriminates against non-Serbs. Two days before the vote, which was protested by the international community, Dodik met with Russian President Putin in Moscow, where he gave his implicit support for the referendum. More than 55 % of voters turned out for the referendum, and 99 % of them approved the motion. Despite strong popular support, Dodik stepped back from his earlier demand for a second referendum – on independence – for the time being.[79] He has, however, not ruled it out, famously stating that his referendum would not lead to bloodshed.[80]

Based on Dodik's actions, the U.S. Treasury Department's Office of Foreign Asset Control sanctioned him for obstructing the implementation of the Dayton Accords and threatening the territorial integrity and sovereignty of Bosnia and Herzegovina in January 2017.[81] Russia immediately criticized the U.S. decision and firmly backed RS' President.[82]

Since September 2017, President Dodik has also reactivated another referendum, with roots that date back to 2015, to negate the legal powers of the courts and prosecutor of Bosnia and Herzegovina, which would de-facto make RS independent from the interference of Bosnia and Herzegovina, paving the way for RS's secession.[83] Such a referendum could have had the potential to divert public attention away from a Dodik corruption scandal involving his family's real estate development, which unfolded around that time.

In October 2017, Dodik reiterated his objections to NATO accession[84] and vowed to preserve the country's military neutrality, an objective shared by Russia.[85] RS's Parliament also passed a resolution supporting this neutrality and began a procedure to hold a referendum on joining NATO.[86] In 2015, RS opposed also a start of membership talks with the EU. Dodik described the potential of EU membership the greatest act of treason since the conclusion of the Dayton Accords. In January 2016, Bosnia and Hezegovina submitted a membership application anyway. However, the government has yet to submit a response to the EU accession questionnaire evaluating the country's progress on key issues such as the economy and the rule of law. Without submitting official answers to the European Commission, Bosnia and Herzegovina will not be able to proceed in opening accession talks.

In March 2014, the Russian Orthodox Patriarch gave Dodik an award from the International Fund for the Unity of Orthodox Nations in Moscow several months before parliamentary elections in the entity. During the same visit to Moscow, he reportedly received donations for the same election campaign.[87]

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[79] Vecernje Novosti, (2017). "Dodik: I want RS to secede, but without any bloodshed," 13 November, 2017, accessed as reprinted in B92 on 6 December, 2017 at https://www.b92.net/eng/news/politics.php?yyyy=2017&mm=11&dd=13&nav_id=102786

[80] MacDowall, Andrew. "Bosnia's Serb Republic leader: No breakaway vote next year," Politico, 3 July, 2017.

[81] U.S. Department of Treasury Press Centre – *Treasury Sanctions Republika Srpska Official for Actively Obstructing The Dayton Accords*. 1 January, 2017.

[82] Bugajski, Janusz (2015). "Moscow Upholds Frozen Bosnian State," Center for European Policy Analysis, 3 August, 2015.

[83] Kovacevic, Danijel. "Republika Srpska Postpones State Judiciary Referendum," BIRN, 7 November, 2017.

[84] Dodik has not always been consistent. On occasions, he has also made statements that RS would support NATO accession if backed by a referendum.

[85] TASS (2017). "Bosnia and Herzegovina's Republika Srpska unwilling to join NATO," 26 October, 2017, accessed on 16 November, 2018 at http://tass.com/world/972744

[86] Ibid.

[87] Bugajski, Janusz (2015). "Moscow Upholds Frozen Bosnian State," Center for European Policy Analysis, 3 August, 2015.

Policy Recommendations

In general, the Russian strategy of keeping Bosnia and Herzegovina neutral and blocking integration with the Euro-Atlantic community has been successful. EU talks have stalled, while continued economic stagnation in the country has sapped reforms. The negotiations have not progressed not only because of Russia, but primarily because of the lack of political will among nationalistic political elites to speak with one voice, and the lack of democratic and economic reforms. The lack of an efficient coordination mechanism makes all necessary reforms difficult to implement in practice.

However, Russia has used its economic footprint in key economic sectors to put a dent in efforts to centralize authority over the country's economy. The feuds between the entities' governance of key sectors, such as energy, existed before Russia, but the Kremlin has fueled these divisions to its benefit. To achieve its objectives, Russia has used RS leadership, which stands to directly benefit from increased Russian capital inflows. In an environment of glaring institutional weaknesses in the areas of energy governance, bank supervision, and fiscal prudence, the country, and especially the RS, has become vulnerable to corrosive capital. In the meantime, the Energy Community warned both the state and entity authorities in fall 2017 that Bosnia and Herzegovina could fall under sanctions for non-adoption of the previously-agreed commitment to institute a law on a regulatory body for electric energy and gas, transmission, and the electric energy market, which is a condition of the Energy Community's Third Package.[88] As a result, the country is facing financial penalties and, in the long run, possible removal from the Energy Community. However, the energy sector is by far not the biggest obstacle for the completion of EU talks.

Several key policy recommendations have been identified in the analysis of the economic vulnerabilities created by Russia's economic footprint in Bosnia and Herzegovina:

- Bosnia and Herzegovina must ensure fulfilment of its commitments under the Energy Community.
- Bosnia and Herzegovina should reform the governance structure of its energy sector, so that the natural gas sector is regulated at the level of Bosnia and Herzegovina, in order to avoid duplication of authority and competing energy strategies.
- Bosnia and Herzegovina should commit to a gas strategy for the diversification of its supply sources, so that it can fulfill the EU gas supply security requirement to have at least three sources of supply. In this respect, priority should be given to the completion of the Western Balkan Gas Ring with a link to potential natural gas supplies from the Mediterranean.
- The Council of Ministers should work on reaching a compromise between BH Gas and RS on the construction of only one gas interconnector to Croatia that would supply both entities.
- Bosnia and Herzegovina should implement the EU energy acquis, unbundle power and gas suppliers, and ban the practice of individual gas contracts with Gazprom at the entity level.
- BH Gas and RES should begin talks with Gazprom on a long-term (five-year) contract for the delivery of natural gas to avoid the unpredictability of annual negotiations threatening the security of supply.
- RS's Privatization Agency and the Commission for Protection of Competition should investigate the privatization deal with Zarubezhneft for the acquisition of the biggest oil assets in the country, and should insist on the implementation of the investment clauses in the contract.
- The capacity of the State Investigative and Protection Agency (SIPA) should be boosted to probe money-laundering operations through the banking system, and to identify the ultimate beneficial ownership of investments coming from offshore destinations, which might be used by shell companies for money laundering or other criminal practices.
- The government should centralize and improve banking supervision, including by eliminating the

[88] Balkan Green Energy News (2017). "New Energy Community sanctions for Bosnia and Herzegovina?" 31 October, 2017, accessed on 1 December at https://balkangreenenergynews.com/new-energy-community-sanctions-bosnia-herzegovina/

two separate entity's regulators, to establish a single controlling mechanism.

- Bosnia's Central Bank and the two entities' business registries and statistical agencies should expand their data on foreign investment and corporate ownership.
- The government of Bosnia and Herzegovina and the entity governments should significantly improve the transparency of their decision-making, primarily in public budgeting, deficit financing, negotiations of intergovernmental and other international loans and agreements, and energy and banking regulations.
- Policymakers should publish online detailed reports stating their motives for decisions affecting key sectors, such as energy, banking, and telecommunications, which have implications for the entire economy. These reports should be followed by public consultations with civil society and the private sector. Regulatory bodies should take into consideration reasoned opinions submitted by Independent experts.

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