CENTER FOR THE STUDY OF DEMOCRACY

THE WIND THAT BLOWS FROM THE EAST: RUSSIAN INFLUENCE IN CENTRAL AND EASTERN EUROPE

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After the fall of the Communist regimes in Central and Eastern Europe and the dissolution of the Soviet Union, Europe and the United States transformed their Soviet policy of isolation and containment to one of political and economic integration with the Russian Federation. **With its financial and political networks remaining largely intact, Russia's integration with Europe was successful.** In the past 10 years alone, the value of Russia's global trade has nearly quadrupled from $210 billion in 2003 to $730 billion in 2014, and Russia's trade with the European Union (EU) represented 44.5 percent of its total. Europe grew more reliant on Russian energy and financial resources, and this dependency has provided Moscow with key levers through which it is able to shape the policy debate in European capitals in favor of its interests.

The topic of Russia's influence in Central and Eastern Europe (CEE) has grown in significance after the eruption of the Ukrainian crisis in 2013. The US and EU policy and research communities have scrambled to explain the potential scenarios, tools, and impacts of the Russian influence, as well as propose possible solutions to minimizing its negative effects on European unity. Most studies have focused on traditional and well known already from Soviet-era Russian influence levers, such as military supremacy, energy dependence, and propaganda. The emergence of sophisticated new forms of "hybrid warfare" has been noted, which have allowed Russia to expand its influence in European and global opinion without the latter being able to link such impact to Russia's military actions.

KEY POINTS

- On average, Russia's economic footprint in five of the most targeted by the Kremlin CEE countries Serbia, Bulgaria, Latvia, Hungary and Slovakia has ranged from about 11 percent of the economy (in the cases of Hungary and Slovakia) to an astonishing 22 percent in Bulgaria.
- After 2008 the Russian leadership has **aggressively deployed its resource-based resurgent economic power in combination with old time security networks and skillful use of traditional soft power appeal** to exploit and further strategic vulnerabilities across the countries of Central and Eastern Europe.
- Russia has also cultivated an opaque network of patronage across the region that it uses to influence and direct decision-making. This web resembles a network-flow model, which we describe as an "unvirtuous circle" of Russian influence leading to "state capture."
- Closing this governance gap, in particular in relation to quality of regulatory oversight, public procurement management, and state-owned enterprises governance is critical to reducing the vulnerability to malicious intent arising from Russian economic influence.
- EU institutions and member states should substantially enhance anticorruption and development assistance mechanisms to help the most vulnerable countries build greater resilience to Russian influence.

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The threat and **the risks of Russia's economic influence in CEE have been generally downplayed**, in particular as energy prices and Russian growth have shriveled in 2015 – 2016. Attention has instead focused narrowly on the effects of EU sanctions over the Ukraine conflict on trade and investment.

This policy brief tries to fill in the gaps in understanding the Russian economic footprint by adding to existing metrics of Russian economic influence direct and indirect corporate ownership, and looking into the factors from the wider Russian influence toolbox amplifying their impact[1]. The policy brief expands the knowledge of the nature and effects of Russian influence CEE, and proposes working solutions to reduce potential vulnerabilities without hurting economic relations.

Understanding the Threat

In 2007, President Putin's speech at the Munich Security Conference signaled the beginning of a new era of confrontation between Russia and the United States and Europe. After 2008 the Russian leadership has **aggressively deployed its resource-based resurgent economic power in combination with old time security networks and skillful use of traditional soft power appeal** to exploit and further strategic vulnerabilities across the countries of Central and Eastern Europe. The **tools Russia has used** in expanding its influence are not new to the region. Political and regulatory capture, financing political parties, the whole range of soft power instruments, including historical, religious, and ethnic symbols, Russian international media presence and local media ownership, organizing massive media campaigns (like the anti-shale gas campaign), have compounded economic levers, such as acquiring critical (energy) sector companies to form a potent Russian government toolbox for influence in CEE. A mixture of economic muscling, corruptive (energy-related) mega deals, media propaganda, and geopolitical pressure have cost considerable resources and/or swayed many governments in the region, including those of some NATO members, to adopt policies that are not consistent with their national security needs and trend lines but benefit the interests of foreign private and state interests.

Russia has also cultivated an **opaque network of patronage across the region** that it uses to influence and direct decision-making. This web resembles a network-flow model, which we describe as an "unvirtuous circle" of Russian influence. The circuitous flow can either begin with Russian political or economic penetration and from there expand and evolve, in some instances leading to "state capture." Russia seeks to gain influence over (if not control of) critical state institutions, bodies, and the economy and uses this influence to shape national policies and decisions. Corruption1 is the lubricant on which this system operates, concentrating on the exploitation of state resources to further Russia's networks of influence.

Malign Russian influence in Central and Eastern Europe primarily follows two tracks: one aimed at manipulating a country by dominating strategic sectors of its economy to abuse capitalism and exploit the weaknesses in its economic governance systems; and another that seeks to corrode democracy from within by deepening political divides and cultivating relationships with aspiring autocrats, political parties (notably nationalists, populists, and Eurosceptic groups), and Russian

[1] Based on a recent report titled *The Kremlin Playbook: Understanding Russian Influence in Central and Eastern Europe*, Rowman & Littlefield Publishers / Center for Strategic & International Studies, October, 2016. The policy brief resulted from the joint work of the Center for the Study of Democracy (CSD) and the Center for Strategic and International Studies (CSIS) on a study to understand the impact of Russian economic influence in Central and Eastern Europe in five case study countries of Bulgaria, Hungary, Latvia, Serbia, and Slovakia during 2004–2014 and its possible correlation to the region's general decline in governance standards. The policy brief has been produced with the financial assistance of the European Union, NATO and the U.S. Embassy in Sofia. The contents of this document are the sole responsibility of CSD and can under no circumstances be regarded as reflecting the position of the European Union, NATO and the U.S. government.

sympathizers. While there are specific patterns of conduct within each track, there is no clear-cut path that Russia appears to follow in any case. Rather, a tactical combination of actors and drivers may be used in pursuit of specific strategic outcomes—all of which depend on the unique conditions present within each country thus acquiring a Russian “tailor-made” strategy. Although these two tracks are not mutually exclusive, they represent the path through which Russian interests seem to have penetrated the domestic environment. Depending on the success of either or both tracks, economic and political influence tends to mutually reinforce the other, deepening Russia’s reach within the country.

Russian influence spreads through the **corrosive comingling of public and private interests**. The power to award and reward—primarily through monetary means, but also through monopolistic power and influence—is essential to the transmission function, as it creates loyalty, enabling participants to capture new actors in the domestic environment through the distribution of ill-gained reward. The promise and the protection of perpetual enrichment is the incentive that allows this system to operate, and state resources provide an abundant source of wealth on which these drivers can draw. The “captured” individuals spread their antidemocratic and corruption contagion to others, widening and entrenching this circular system. Thus, Russian influence expands and sustains itself until its ultimate goal of state capture has been achieved. Russian influence has become so pervasive that it has challenged national stability in certain countries as well as their Western orientation and Euro-Atlantic solidarity.

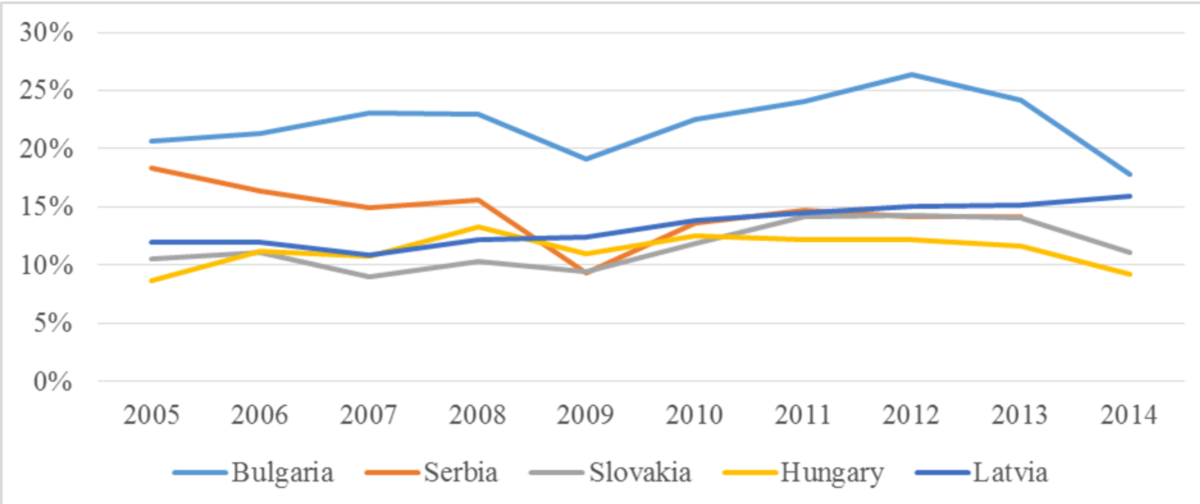
Russia’s Economic Footprint

On average, **Russia’s economic footprint** in five of the most targeted by the Kremlin CEE countries Serbia, Bulgaria, Latvia, Hungary and Slovakia has ranged from about 11 percent of the economy (in the cases of Hungary and Slovakia over the course of the study period) to an astonishing 22 percent in Bulgaria.

The Russian economic footprint in these countries was determined by examining Russia’s corporate presence, direct investment, trade relationships (e.g., bilateral account balance), and private ownership and investments. Turnover, assets, and employment indicators for Russian-owned and controlled companies in each of the country case studies was used to estimate the share of Russian business in the overall economy, as these are the best proxies for the Russian economic footprint as share of GDP and can be easily compared.

The full extent of Russia’s reach, however, remains unknown as Russia has sought to conceal its economic activity behind a web of foreign shell companies and offshore accounts. As a result, the official economic data tends to be skewed. The Netherlands, for example, is listed as the single largest investor in Bulgaria due to the fact that Russian giant LukOil is registered there. In this way, Russia’s true presence is masked, and this lack of awareness about the region’s structural economic relationship with Russia has left it vulnerable to manipulation. As a result, the potentially negative consequences that Russian investment has on the quality of governance in the recipient country are also obscured.

Figure 1 Russian Economic Footprint as Sum of Four Indicators: 1) Energy Imports as share of GDP, 2) Total Exports to Russia as a share of GDP, 3) FDI Stock by Ultimate Beneficial Ownership from Russia as a share of GDP, 4) Revenues controlled by Russian Companies as share of the Total Revenues in the Economy



Source: CSD calculations based on EUROSTAT, data from National Central Banks and corporate databases

There are different **mechanisms that Russia uses in order to amplify its economic influence** in the CEE region including:

- Playing on structural economic vulnerabilities on bilateral level;
- Exploiting governance deficits, e.g. in state-owned enterprises, regulatory bodies, the court system, the tax authorities, etc.;
- Capturing influential policy-makers and/or power brokers through corruption or intimidation;
- Leveraging corporate profits and presence;
- Pulling old time security networks' strings; and
- Raiding pred-89 shared assets.

The exposure of Central and Eastern European countries to Russian capital is not the problem per se. It is how Russia uses its economic leverage.

In the first place, Moscow has become adept at using its influence to preserve and expand its dominance of the oil and gas markets, exploiting governance loopholes to manipulate top-level decision-making, and capturing regulatory institutions to prevent market liberalization and competition. Secondly, it has become abundantly clear that Russia is not interested only in business. In fact, it seeks to use its considerable and growing resources to undermine Europe's established liberal-democratic consensus and to elevate the Russian "power vertical" as an acceptable alternative. The combination of the two factors may have been used to provoke government change, the rise of bogus extremist or nationalistic parties, the shift in foreign policy priorities and the opposition to EU common legislative initiatives. Additionally, the domestic Moscow proxies echo Russian interests or lobby for a pro-Russian policy stance.

The Amplifiers of the Russian Economic Footprint

Energy has been the most visible and well-studied channel for Russian economic influence in Europe[2]. Energy trade has been the core element in persistent trade deficits of the five countries under review with Russia. Hungary, Slovakia and Latvia have been able to partially offset it after their EU accession in 2004 by rising manufacturing investment from the EU, and exports to Russia. Meanwhile, Serbia and Bulgaria have remained locked in an unbalanced economic partnership with Russia due to their inability to build up a competitive export manufacturing base. For example, in terms of share of exports in 2013, Russia received just 2.6percent of Bulgarian and around 7.2percent of Serbian, but a quarter of all Slovakian extra-EU exports. In terms of imports, in all of the countries, between 75 and 90percent of the Russian imports are of crude oil and natural gas. Hungary, Latvia and Slovakia also import a significant amount of oil products from Russia, which in Bulgaria and Serbia are produced locally by Russian dominated industry. Slovakia and Bulgaria in particular, stand out as the most vulnerable in terms of energy imports from Russia, each with an average share of energy imports of above 9 percent over the decade since 2004.

The trade deficit vulnerability of CEE countries is closely linked to their energy dependence, and the costs of their energy imports from Russia. Oil and gas imports make up around 12percent of GDP in Bulgaria and more than 8percent in Slovakia. All five countries remained on average more dependent on natural gas and crude oil from Russia than their EU peers did. The dependence of any of the five countries on Russian gas as a share of the domestic consumption has never fallen below 60percent in the past decade, and has usually stayed above 80 percent since 2004. The overall energy dependence from imports of the selected region has also remained high. With the exception of Bulgaria and Serbia, which rely on own coal and hydro resources, Latvia, Slovakia and Hungary have had to resort to imports for the majority of their energy needs[3].

Because of their energy dependence on Russia and insufficient integration into EU markets, the countries in Central and Eastern Europe under study have on average paid between 10 percent and 30 percent more for their Russian natural gas imports than Germany over the past decade. The price German suppliers pay is close to 3.4 percent below the average Gazprom price charged on average to European clients. It seems that price differentials are largely determined not by market conditions but by the level of the natural gas dependence of each of the countries in the region, by whether they have operational interconnections with neighboring markets and, by their ability to influence the gas contract terms in bilateral negotiations with Russia[4].

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[2] For a recent review of the use of Russian energy policy as a tool for influence see Michael Rühle and Julijus Grubliauskas, *Energy as a Tool of Hybrid Warfare*, *NATO Research Paper, No. 113* (NATO, April 2015).

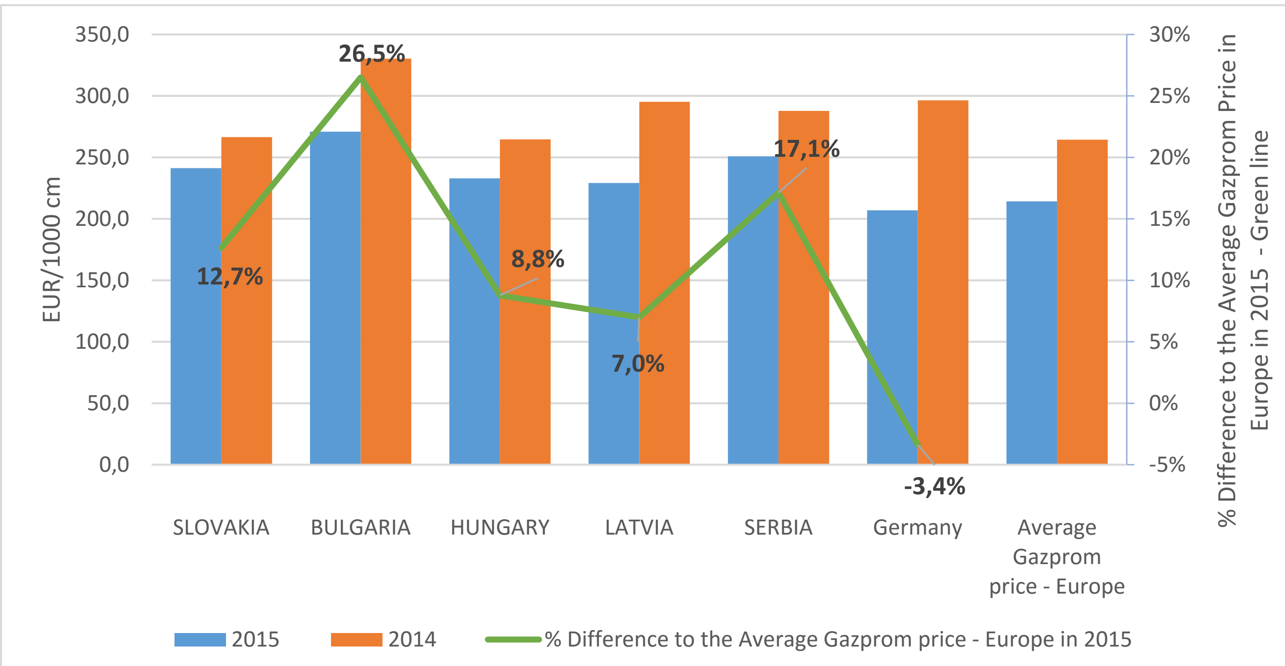
[3] Institute for 21st Century Energy, *Index of U.S. Energy Security Risk* (U.S. Chamber of Commerce, 2015), http://www.energyxxi.org/international-energy-security-risk-index. For a more detailed discussion of the energy security situation of Bulgaria, Serbia, Romania and Ukraine using as a basis this methodology, see Center for the Study of Democracy, *Transparent Governance for Greater Energy Security in CEE,* CSD Policy Brief 58, (Sofia: CSD, 2015), http://www.csd.bg/artShow.php?id=17515.

[4] The European Commission has launched an anti-trust investigation against Gazprom on price discrimination in CEE 2012. In April 2015, the EU opened a formal procedure, which could lead to high anti-trust penalties and a change in Gazprom's practices in CEE. Gazprom denies any wrongdoing and has requested an additional

The economic explanation for the lower price Germany pays for Russian gas usually provided in price disputes that it receives a quantity discount, does not hold if one compares the volume-adjusted prices in Ukraine and Turkey, which are paying some of the highest gas import prices in Europe. There exists a wide body of knowledge and evidence that Russia has used Gazprom to punish or reward CEE countries depending on their foreign policy stance on Russian commercial and political interests[5].

Current long-term contracts between the national gas incumbents in CEE and Gazprom will last until the early 2020s incurring huge losses for the gas customers in the countries under study. The Bulgarian state-owned gas company, for example, will overpay Gazprom around EUR 1.1 billion over the next five years until the end of its current long-term contracts, a sum constituting a third of the average annual EU development aid for Bulgaria until 2020.

Figure 2. The Natural Gas Import Price in CEE in Absolute Terms and Relative to the Average Gazprom Price for Europe



Source: CSD calculations based on the COMEX statistics on international trade – EUROSTAT, and Gazprom data

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oral hearing with the EC in late 2015, using the occasion to launch a wide media campaign against EC charges.

[5] See for example Kostiantyn V.Vagin, *Russian Energy Policy vis-à-vis Europe: Natural Resources as a Means of Foreign Policy*, Thesis, (Monterey, California: Naval Postgraduate School, June 2012).

Part of the explanation for the strong influence of Russian interests in the formation of energy decision-making in CEE are the close ties between Russian and local energy companies, and the uninhibited reach the Russian political elite has in Russian state-owned and private companies abroad[6]. Russia's influence on the domestic energy sector is revealed via past collaborations in **energy infrastructure, long-term supply contracts, and ongoing technology transfer** with CEE national monopolies. Overtime, these factors have influenced not only the inner structure of the CEE economies but also the formation of domestic political elites. Such economic dependencies have grown very strong in the oil, gas and nuclear sectors based on rigid infrastructure, inflexible contractual obligations, and partitioned market. The participation of Russian interests and local, Russian-controlled oligarchs in the privatization of the vertically integrated monopolies from the central planning times in CEE has allowed them to provide access of local political elites to illegitimate resources through layering of profits between what now appear to be independent companies.

The impact of Russian foreign direct investment in the region has also been downplayed for a variety of reasons. (i) it is wrongfully compared to that of the entire EU without taking into account that unlike Russia, the EU is not a unitary entity, and FDIs originating from different EU countries are not the result of a common government economic policy; for proper assessment Russia's FDI footprint in CEE should be compared to that of individual EU countries; (ii) hidden Russian FDIs channeled through offshore and tax havens have not been fully accounted for, including their potential negative consequences for the quality of governance in the host country[7]; and (iii) the capability of the Russian government to intervene and use FDI as a foreign policy tool is naively overlooked. Although Russian investments in the five CEE economies have been growing over the past decade, in some cases substantially, they are dwarfed by the total investment coming from the EU. However, if Russia's investment presence in the five CEE countries is compared instead with that of the largest European economy Germany alone, it becomes clear that Russia's investment presence, in particular in some economies, is sizable. Germany is much better represented in Hungary and Slovakia as opposed to the other three smaller economies. German foreign direct investments made up more than 10 percent of the Hungarian GDP in 2012, and this is likely to be an underestimation considering that many German companies are investing in the CEE region through Austrian-registered or offshore entities[8]. Germany is a smaller investor in Bulgaria, Serbia and Latvia, where its investment stock represents an almost identical or smaller share of the GDP compared to that of Russia.

Where Russian investment in CEE has been most visibly leveraged to achieve political objectives and influence governance standards, are **the large-scale energy projects**, launched in the whole region after 2006. Their sheer size relative to the CEE economies and the national budgets made them game changers

[6] For a detailed assessment of the Russian state-owned enterprises in CEE on the example of Gazprom and Rosatom see Martin Jirušek and Tomáš Vlček (eds.), *Energy Security in Central and Eastern Europe and the Operations of Russian State-Owned Energy Enterprises* (Brno: Masaryk University, 2015).

[7] For an overview of the effects of shadowy Russian capital access to EU markets see Ben Aris, "Russian money infects London", Business New Europe, *Intellinews*, March 31, 2015, http://www.intellinews.com/russian-money-infects-london-500445373/?archive=bne

[8] Austria is one of the largest foreign direct investors in all countries in Central and Eastern Europe and the Western Balkans.

in terms of bilateral investment relations. The prospect of future cash flows and Russia's ability to use the energy dependence as a trading card enable it to **structure the large-scale deals in such a way** as to appoint well-linked domestic and Russian companies to win the bulk of procurement contracts under these large-scale projects, creating **substantial rent-seeking opportunities**. Russia-leaning governments also used the grandeur of some of these pipelines, power plants and refineries to win popular support from citizens. Meanwhile, behind the disguise of "strategic" concerns, the same governments amended laws and shifted policy priorities to accommodate the Russian-led initiatives. Although not all of these projects have materialized or will materialize in the future, they have partially already achieved their goal, namely to prevent needed structural changes in energy markets and to capture influential local policy actors that can later be activated when Russian interests might need it.

Russian companies have also invested in sports and cultural activities to expand Russia's soft power in Latvia, Serbia and Bulgaria, pressured local governments not to investigate non-transparent mergers and acquisitions, adopt preferential tax regimes and forestall market liberalization reforms. In Bulgaria, Lukoil, a Russian oil company and the largest in the country by revenues, has not reported a profit nor paid any profit tax since 2005, despite having over 32 billion euros of revenue during that period. Russian businesses have also financed media outlets in Serbia, Bulgaria and Latvia that have on many occasions taken a pro-Russian stance.

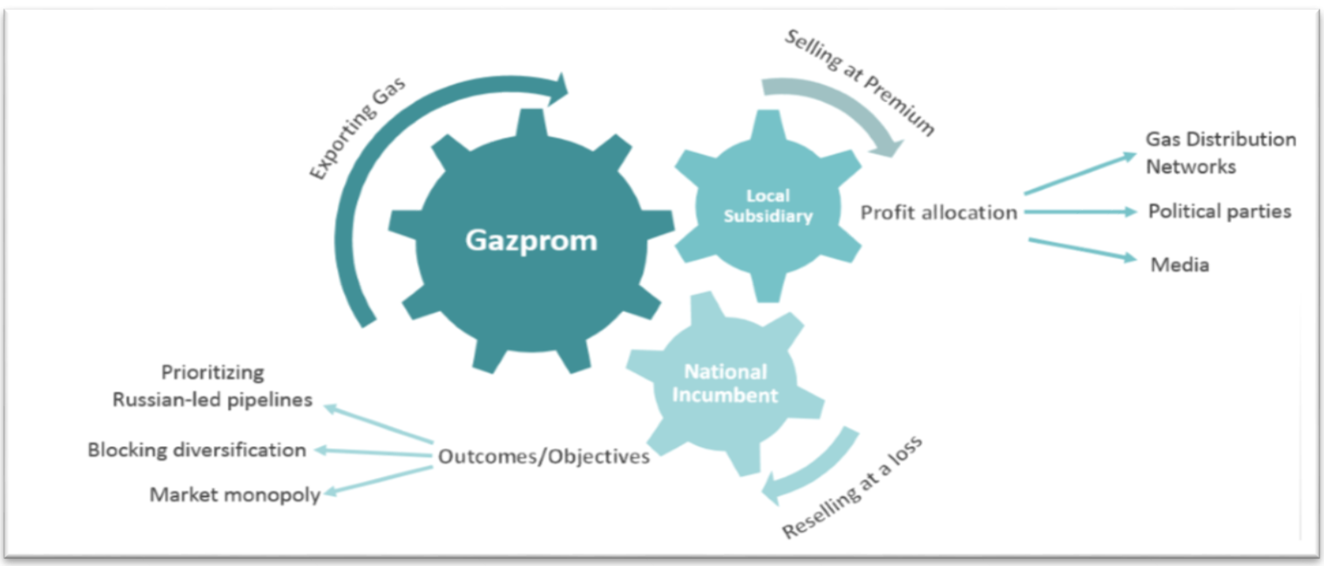
There are several drivers through which Russia channels its economic influence. These drivers are highly versatile and can be utilized flexibly to influence the local economy and policy environment. One or a combination of these drivers may be employed depending on the nature of the national and local operating environment (weak regulations and oversight, for example) and the composition of Russia's economic presence there (based on trade and investment ties, as well as the extent of Russia's corporate structure).

First, Russia has sought to maintain its influence by **cultivating a network of local affiliates and power-brokers who are capable of advocating on Russia's behalf**. These affiliates are often wealthy and influential businessmen or former high-ranking public officials who are able to influence decisionmaking. Typically, Russia entices these individuals into its service by offering them lucrative business opportunities in which the Russian government is involved, and provides premium returns to its clients. These awards are doled out through nontransparent public procurement tender processes; through overinflated contracts that often exceed the actual cost of the services procured; or through access to well-paid board positions. Once "captured," these contacts are then used to advance Russia's interests politically and economically. They are often the most vocal advocates of Russian-led projects, and they are strongly opposed to efforts to diversify commerce away from Russia. Russia also possesses a preexisting cadre of Soviet-era contacts (primarily originating through the security services) that it can utilize as well, as many of these networks remain intact and are integrated into the contemporary business and political environment. Russia can call on these agents to channel its influence into the local environment. This channel does not just operate one way, however, and local business affiliates have also been known to rely on their Russian connections to provide vital capital and political backing to acquire additional assets and investments in large projects in their national economies. In this way, Russia appears to have created a **mutually reinforcing network of patronage** that rewards loyalty with loyalty—with increased financial compensation.

Russia has also capitalized on the region's opaque business environment and weak regulations to enable large Russian companies (including state-owned enterprises) to manipulate economic conditions in the local environment and deliberately exploit Russia's dominant position in strategic sectors. These entities serve as intermediaries between Russia and the network of local affiliates, but can also play an important function themselves. In several instances, they have become major investors in the domestic economy, providing much-needed foreign direct investment, and are among the greatest contributors to national budgets in terms of tax revenues, creating a significant exposure to Russian manipulation. But by positioning these companies in sectors where there tends to be a significant degree of state intervention, deficiencies in the management of public resources. Perhaps the best example can be seen in the operations of the Russian state-owned gas giant, Gazprom. Conducting business in each country through a network of intermediaries, Gazprom—facilitated by its near-dominance of regional gas markets and the lack of any viable competitors—is able to influence the financial and market positions for its local distributors in these countries. The European Commission is currently investigating Gazprom's activities in Central and Eastern Europe, having alleged that it abused its dominant market position in breach of EU antitrust rules [9] .This influence can then be used to back up Russia's strategic initiatives or incentivize other local players.

In some cases, surcharge profits have been reinvested in the financing of local political actors

Figure 3. Model of Capturing Energy (Gas) Markets through Intermediaries and Profit Layering



Source: CSD

Russia has also provided them with the opportunity to redirect state funds by exploiting the structural and parties in a nontransparent fashion, facilitating greater political influence. These profits are also

[9] European Commission, "Antitrust: Commission Sends Statement of Objections to Gazprom—Factsheet," April 22, 2015, http://europa.eu/rapid/press-releaseMEMO-15-4829en.html.

likely to finance media and protest campaigns that further Russia's political and economic interests. In this way, Russian companies have been able to commandeer state resources and enhance their "profits" and networks, all in pursuit of Moscow's strategic political objectives.

State Capture: the Ultimate Prize

Russian influence in CEE follows two primary tracks that can be generally described as economic and political. The first is aimed at preserving its core business interests such as the quasi-monopoly on oil and gas markets by buying out strategic energy companies, exploiting governance loopholes to manipulate top-level decision-making and capturing regulatory institution to prevent market liberalization and competition. The second seeks to undermine the established liberal-democratic consensus in Europe, and in this way elevate the Russian 'power vertical' as an acceptable alternative. Russia attempts to sow mistrust in the sustainability of democratic institutions by deepening political divides and cultivating relationships with aspiring autocrats, political parties (especially nationalists, populists, and Eurosceptics), and NGOs.

In the identification of a distinct sets of drivers, tactics, and instruments, a clear commonality emerges: both systems of economic and political capture rely on corruption as the conduit through which Russian influence is channeled into the local environment and ultimately expanded. The drivers of Russian influence seek to exploit existing deficiencies within the democratic fabric of the state. **Political influence** is secured by fomenting popular discontent and exposing the vulnerabilities of the liberal democratic system of governance. **Economic influence** is secured by attaining a dominant position in strategic sectors on favorable terms, and then robustly defending this dominant position by all means available. Within these two tracks, Russian political influence and Russian-linked economic acquisitions gravitate toward sectors where generous state resources and state-owned assets play a critical role in market making.

To preserve their dominant market position and engage government in large energy projects, Russia's strategy has been to capture powerful local brokers by providing them with lucrative government-sponsored business opportunities infiltrating them in state-owned companies, national agencies including in the security sector. Another common way is to use former security officials with significant influence over parties, businesses and institutions to act as intermediaries boosting Moscow's interests where necessary.

Russia's strategy is simple and straightforward: it exploits the inherent weaknesses within the Western capitalist democratic system. It is the lack of rigorous oversight and transparency of our governance standards that are readily available for exploitation, but Russia is not the only source and driver of corruption. All countries struggle with corruption and corruptible individuals in both the public and private sectors, but Russia uses it as an instrument of statecraft that is highly adaptable and poised to easily take root in new environments, making nearly all countries susceptible. Distinctive features of the combined effects of economic and political capture related to Russian interests include the circumvention of established formal rules of transparency and democratic definition of national interests, as national administrations have been replaced by private companies in drafting rules and regulations, while the same private interests eventually become the final beneficiaries of greater access to public resources[10].

What has allowed this Russian-influenced unvirtuous cycle to persist and proliferate undetected? The enabler is Western complicity in corrupt practices and Russia's exploitation of this complicity to ensure opaqueness and nontransparency. Recent leaks such as the Panama Papers highlighted how Russian entities are linked to local actors in the region through a combination of companies and offshore accounts. Although many of these transactions are considered legitimate and legal, they are opaquely designed to exploit and benefit from the loopholes in democratic frameworks with a specific purpose to acquire influence, power, and strategic assets. Where such malfeasance can be identified, it is not obvious and requires deliberate and thoughtful investigation. The West is, in fact, culpable in Russia's acquisition of influence by allowing the Kremlin to systemically exploit these vulnerabilities.

Resisting Russian Influence and Policy Recommendations

Understanding the depth and the characteristics of the Russian economic footprint in CEE, as well as how it relates to the other aspects of influence, such as soft power, intelligence, cyber presence, military capabilities, etc. is the first step of devising proper response mechanisms to address potential related vulnerabilities. While in the military domain Russia's capabilities have been measured in absolutes, e.g. whether the country is able to threaten the existence of its neighbors[11], **in the economy, it is the marginal changes and network effects** that have mattered the most, or such that can contribute to building up hybrid warfare capabilities. In this respect, working policy solutions and strategies to track and tackle Russian economic presence risks should be balanced. They should acknowledge that cutting off access to CEE markets would hurt many legitimate economic interests, furthering adverse selection on the Russian side. At the same time, they should not underestimate Kremlin's reach into economic instruments to further political goals, not just in energy sector. The following non-exclusive list of policies should be considered[12]:

- **Elevate and design a specific, high-level task force within the Treasury Department's Office of Financial Crimes Enforcement Network that focuses solely on tracing and prosecuting illicit Russian-linked financial flows if they interact with the U.S. financial system.** The United States should dedicate a specific unit to tracing and mapping illicit Russian

[10] These governance deficit patterns have been particularly pronounced in Southeast Europe and are well described in Southeast European Leadership for Development and Integrity (SELDI), Anticorruption Reloaded: Assessment of Southeast Europe (Sofia: Center for the Study of Democracy, 2014), http://seldi.net/fileadmin/public/PDF/Publications/RAR/SELDIRegionalAnticorruptionReportFinalRevised.pdf.

[11] See for example the debate on the Russia posing the greatest threat to the U.S. during the nomination hearings General Joseph Dunford, Jr., USMC to be Chairman of the Joint Chiefs of Staff to the United States Senate Committee on Armed Services on July 9, 2015: http://www.armed-services.senate.gov/hearings/15-07-09-nomination, and the assessment of Lt. Gen. Vincent Stewart, Director of the Defense Intelligence Agency and James R. Clapper, Director of National Intelligence on Worldwide Threats at a hearing in the United States Senate Committee on Armed Services on February 26, 2015: http://www.armed-services.senate.gov/hearings/15-02-26-worldwide-threats.

[12] Based on the findings of *The Kremlin Playbook: Understanding Russian Influence in Central and Eastern Europe*, Rowman & Littlefield Publishers / Center for Strategic & International Studies, October, 2016.

financial activity. Presently, FinCEN is primarily focused on anti-Daesh and terrorism financing investigations, but the body is also charged with the task of safeguarding the U.S. financial system from money laundering and national security threats—including kleptocrats and rogue regimes. A unit dedicated exclusively to the understanding and identification of Russian financial activity would be an important contribution to breaking the unvirtuous circle of Russian influence. This unit should place liaison officers in key U.S. embassies in Europe and closely cooperate with European financial and intelligence officials to uncover and prosecute these networks. The information collected by this unit, when applicable, should be made publicly available through a database that could help expose beneficial ownership of companies and opaque business transactions of systemic importance.

- **CEE countries should pay particular attention to strengthening national financial intelligence units and their cooperation within the EU and with the US.** They should assess and consider undeclared, cross-border money flows invested in strategic areas or economic sectors of the economy. In that respect, law-enforcement and tax inspection bodies should recognize the role of grey economy practices such as layering, unregulated transfer pricing mechanisms and contraband energy flows in destabilizing the financial system, and in financing grand corruption schemes. In order to achieve this, the CEE governments need to take steps in ensuring mechanisms for better and more effective cooperation between revenue authorities, customs, and law enforcement agencies.
- **Strengthening national economic policy-making and regulatory governance, transparency, and independence in view of increasing market diversification and competition**. All CEE countries have considerably lower governance and regulatory quality rankings than their Western European peers. Closing this governance gap, in particular in relation to quality of regulatory oversight, public procurement management, and state-owned enterprises governance is critical to reducing the vulnerability to malicious intent arising from Russian economic influence.
- The example of Ukraine has shown that the existence of local economic concentrations and oligarchic structures considerably increases the vulnerability to Russian influence. CEE countries still face similar threats in the energy sector. Moreover, in Hungary and Slovakia early economic diversification following the exit from the Soviet system has aided economic growth and reduced Russian influence vulnerability potential. **Achieving better regulatory quality and economic governance would require continuous US and EU level engagement, assistance, and investment.** Left on their own no single CEE country can be a match for Russian majors, in particularly if backed up by Kremlin.
- **CEE governments needs to revamp and strengthen their capacity to counter effectively the instruments of Russian influence in critical sectors of the economy and energy.** These efforts should be part of the national security strategies and included publicly in the annual reporting/threat assessment on Russia, including its economic and energy presence. A good example in this respect has been the work/annual report of the Czech national intelligence service BIS.
- **U.S. government assistance to Central and Eastern Europe and the Western Balkans must be completely revamped to prioritize combating Russian influence and strengthening governance.** As the Treasury Department's role is to root out malign Russian economic influence, the role of the U.S. Agency for International Development (USAID) and the State Department must be to strengthen governance practices.
- **EU institutions and member states should substantially enhance anticorruption and development assistance mechanisms to help the most vulnerable countries build greater resilience to Russian influence.** The European Union is by far the largest single donor for the Western Balkans and its new member states. As democratic and rule-of-law standards have eroded in Hungary, Slovakia, and Bulgaria, the European Union has been unable to formulate rapid and strong responses to these challenges, which reduces the union's cohesion and is seized on by those who wish to capitalize on the situation.