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## UKRAINE CRISIS COULD REFRAME EUROPEAN ENERGY POLICY

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The leading players in the looming disaster that is Ukraine understand too well what the only viable solution can be, however much they might disagree on the details and the timing – elected regional government in a federal state with strong protection for regional interests. It has been obvious to any outside observer that, since it became independent in 1991, Ukraine's very diverse identities cannot be ruled by one of them, pulling in one single geo-political direction, be it Russia and its Eurasia Group or the European Union.

What is being overlooked in today's increasingly volatile situation is the economic cost which all parties to this conflict will suffer if the country continues to disintegrate before our eyes. Law enforcement in the eastern Donetsk region is characterised by seasoned observers as a power structure in which local thieves control the local police, the Security Service of Ukraine (SBU) controls local thieves and the Russian Federal Security Service (FSB) controls the SBU. The respected commentator, Dimitri Trenin suggests the growing disenchantment with the February revolution has strengthened oligarchical rule in the country. In this increasingly surreal form of anarchy, there seems little recognition that, in economic terms, this is a zero sum game with incalculable economic and energy consequences for all parties, albeit to different degrees. Rational behaviour would suggest all actors to Russian roulette stop before it is too late, but players in this game must be willing to go to the extreme brink, in fact be prepared to lose in a crude display of courage. What are the economic and energy consequences of each party failing to attain its desired outcome?

In a report published on 6 May 2014, the International Monetary Fund cut its forecast for growth in 22 central and east European countries from 2.7% last October to 1.9% and in Russia from 3% to 1.3%. Central and east European countries would see their growth fall from 3.3% to 2.6%. There will be a further substantial downward revision to Russia's forecast going forward and the outlook for foreign investment in Russia will drop sharply. Lower economic growth will hit Russia's neighbours such as Belarus, the Baltic states and Moldova through trade and remittance flows. The leading multilateral investment bank for the region, the European Bank for Reconstruction and Development more than halved its 2014 growth forecast for the ex-communist economies of eastern Europe and the Soviet Union. At its annual meeting in Warsaw, it forecast that Ukraine's economy would contract by 7% in 2014 while Russia's would grind to a standstill.

Were the European Union and the United States to escalate sanctions on Russia over

its annexation of Crimea and the help it is giving certain groups in eastern Ukraine, contagion would quickly spread through the banking system and affect asset valuation. Banks in Austria, Cyprus and Hungary, with bank exposures equivalent to 4-13% of gross domestic product, mainly through local subsidiaries would find their profitability hit hard but the parent banks would not be in danger. Central Europe has little exposure to Russia through exports – the two key countries here are Germany and the Netherlands. Switzerland the United Kingdom could benefit from haven status if tensions escalate: capital flight from Russia has already reached \$50bn in 2014 and could go much higher if tensions escalate.

Ukraine of course risks economic implosion and a severe financial crisis. It would become even more dependant on external financial assistance and the conditionality which comes with it, be it from Russia or the IMF, depending on the political and military outcome of the conflict. The consequences of an escalating conflict could scar Ukraine's economy for a generation, particularly if it leads to a large brain drain.

Russia's credit rating has been cut to just one notch above junk level. Prospective Western sanctions that targeted Russia's financial sector would result in higher inflation and accelerate capital flight which could lead to a collapse of foreign investment. Servicing Russia's foreign debt and opening letters of credit would, in such circumstances, become more difficult. Syndication activities by banks has already decreased dramatically and three Treasury auctions have failed in Moscow. Companies doing business in Russian are finding it more difficult to access finance.

Were Russia's president, Vladimir Putin, to retaliate against such sector-focused sanctions, the disruption of oil and gas supplies to Europe would push the price of energy up and bring the continent's growth to a halt. Central and south eastern Europe depend on Russia for the bulk of their gas imports, so any disruption in supply would hit that region's economy hard. About 40% of Europe's overall supply of natural gas comes from Russia. Reducing Europe's reliance on Russian gas cannot be done quickly but the European approach must be driven by competition alone – geopolitics are crucial. Gazprom is about to start building the South Stream pipeline from the Black Sea to Austria with the aim that Russia will provide much of the gas that eventually passes through it to Europe.

The Commission has warned that, under the EU's "third energy package", other gas suppliers must be given access to South Stream. This could restrict Russia to providing no more than half of the gas that passes through the pipeline. It could also deter some investors from lending to the South Stream project. The Commission's move can be amply justified on competition grounds alone because Gazprom is seeking to control the South Stream supply chain, providing gas upstream, distributing it downstream and owning the pipeline itself. This runs contrary to Europe's energy liberalisation agenda and must be unbundled.

The EU must however work on a broader canvas and secure gas from a wider range of sources. It already backs non Russian schemes such as the Trans-Adriatic pipeline that will bring from the Caucasus via Turkey. It should strengthen its strategic ties with Algeria, its third largest supplier of gas (which passes through three pipelines under the Mediterranean) and encourage the building of a fourth, the Galsi which would deliver Algerian gas to the north east of Italy via Sardinia. It should make greater use of Libyan gas and import gas from Iran if and when sanctions are eased. Such moves would strengthen the EU Mediterranean policy by providing it with a much stronger economic underpinning than hitherto.

The danger the world faces today is that the set of options available to the four parties to this conflict – Ukraine, Russia, the European Union and the US, are narrowing as each party loses control over developments on the ground. Growing internal Ukrainian fragmentation and hard hitting sector-focused sanctions leading to a tit

for that response from Russia could lead to a hefty bill which all parties involved, and the wider world, will have to foot. Is it too much to hope for that the Ukrainian crisis leads to more defensive policy on issues relating to Russian gas? One can only hope that the terms of the debate on the continent's energy security are reframed.

The West seems to have learned nothing from the humiliation it suffered in Georgia in 2008. Nor did it learn anything from previous disruptions of gas deliveries from Russia due to disputes between Moscow and Kiev. The severity of today's crisis will hit economic growth across Europe. It could tip Europe into recession and a slowly healing US economy is unlikely to be able to compensate fully to stabilising the world beyond Europe. De-escalating the crisis is Europe's first priority, reframing its energy policy is the second, a third might be using this opportunity - among other objectives, to think more strategically about its energy links with southern rim Mediterranean countries.