

ANALYSIS OF THE REGIONAL ECONOMIC IMPACT OF HYBRID CONFLICTS ON TRADE RELATIONS

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***Abstract:** In the last period, the international economy is marked by a diversity of fundamental transformations that reshape the architecture of the interdependencies on the basis of which it operates. The World Trade Organization has seen preliminary signs of fragmentation in trade flows, with exports and imports reorienting along geopolitical lines. Trade can contribute to the propagation of shocks because it exposes economies to external risks, but it can also be a source of shocks. The positive effect of trade on resilience has been demonstrated by recent crises, including the COVID-19 pandemic and the war in Ukraine. Since the start of the war in Ukraine, trade has played an important role in the adjustment of net food importing countries. As with economic security, trade can theoretically increase or decrease the likelihood of conflict. In theory, the relationship between trade and economic security is not very clear. The multilateral trading system incorporated by the World Trade Organization is fundamental to achieving the resilience benefits of international trade by helping economies obtain inputs from around the world on transparent and comparable terms. The war in Ukraine highlights that this allows rapid adjustment of trade flows when unforeseen shocks occur.*

***Keywords:** international trade, conflict, geopolitics, resilience.*

***JEL Classification:** F51, F53.*

1. Introduction

In recent years, a series of crises have changed the way trade, interdependencies between states and the trade-security relationship are viewed. What was considered essential for economic progress and security is sometimes seen today as a source of risks that must be limited. Furthermore, security concerns are no longer expressed only in reference to conflicts, but cover the much broader notion of economic security. Despite disruptions in global supply chains, trade remains a source of security, especially when part of a rules-based multilateral system. Trade provides greater economic security by helping economies better prepare for, cope with, and recover from shocks. Trade increases the resources available to invest in security by amplifying income. It facilitates the efficient delivery of essential services such as insurance, telecommunications, logistics and health services. It allows economies to adjust more easily to shocks by providing them with new sources of supply in the event of a shortage in the domestic market or other markets in the event of a fall in domestic demand. Beyond crises, the diversification effect produced by trade reduces asymmetric dependencies as well as the likelihood that suppliers in a dominant position can use trade as a weapon. In fact, trade has always been a source of economic security. Empirical research often shows that the beneficial effects of trade on resilience outweigh its harmful effects. Over the past 50 years, greater openness to trade has limited macroeconomic volatility in most economies. The positive effect of trade on resilience has been demonstrated by recent crises, including the COVID-19 pandemic and the war in Ukraine. Since the start of the war in Ukraine, trade has played an important role in the adjustment of net food importing countries. The sharp drop in Ukrainian grain exports to several African economies was expected to be offset by an increase in grain exports from other major grain suppliers, including Argentina, France and the United States. The multilateral trading system embodied by the WTO is fundamental to reaping the resilience benefits of international trade. It helps economies obtain inputs from

around the world on transparent and comparable terms. The war in Ukraine highlights that this allows rapid adjustment of trade flows when unforeseen shocks occur.(WTO, 2023)

Trade tends to reduce the likelihood of conflict. As with economic security, trade can theoretically increase or decrease the likelihood of conflict. The literature identifies three main mechanisms by which trade increases the likelihood of conflict. First, trade generates economic dependencies. These dependencies can limit the range of actions available to policy makers and expose countries to the effect of changes in the rules or policies of some governments. Second, trade relations can be a source of conflict, as demonstrated by the war between England and the Netherlands and the continental blockade instituted by Napoleon, which aimed to control, respectively, sea trade routes around the world and the European market. Third, trade increases economic output and therefore resources that can be used in conflict. These conflict-inducing effects of trade are counterbalanced by at least four mechanisms by which trade reduces the likelihood of conflict. First, trade increases the opportunity costs of conflict. If two economies with close trade ties went to war, both would suffer economically. Second, trade promotes openness to change and mutual understanding. It can help improve communication and encourage contacts between public and private actors in different economies. Third, trade redirects resources within economies to benefit interest groups with an interest in peaceful and stable relations. Fourth, trade provides non-violent tools in crises. Measures that, for example, would impose import barriers or export restrictions and ultimately suspend trade would effectively address disparities related to information asymmetry. (WTO, 2023)

Empirical work supports the idea that trade has a pacifying power, although it is certainly not capable of preventing conflict. Most empirical studies conclude that the conflict-reducing effect of trade tends to be stronger. Figure 1 presents data that clearly supports this, showing that there has been an inverse relationship between trade openness and the likelihood of conflict since World War II.

Figure no. 1. There is a strong correlation between trade openness and lower conflict probability



Source: (WTO, 2023), p.55

Various works focusing on bilateral trade concluded that a doubling of trade between two economies reduced the probability of conflict by 20% on average, a finding confirmed by numerous studies. Particularly in terms of trade openness at the country level, multilateral interdependence reduces the likelihood of conflict. Recent studies show that both bilateral and multilateral interdependence foster the promotion of peace. Greater bilateral trade

independence contributes to a peace effect for neighboring countries, while openness to global trade promotes peace between more geographically distant economies. (WTO, 2023)

2. Analysis of the impact of the conflict in Ukraine on regional trade

2.1 EU-Russia relations – general framework

The Bilateral Partnership and Cooperation Agreement (PCA) has been the general framework for the EU's political and economic relations with Russia since 1994. The trade-relevant sections of the PCA aim to promote trade and investment and develop mutually beneficial economic relations. At the 2003 St. Petersburg summit, the EU and Russia strengthened their cooperation by creating four "common spaces": an economic space; a space of freedom, security and justice; an external security space; a space for research, education and culture. At the regional level, the EU and Russia, together with Norway and Iceland, initiated cross-border cooperation in the Baltic Sea and Barents Sea region in 2007. In July 2008, negotiations began for a new agreement between the EU and Russia, which was to include "legally binding commitments" in areas such as political dialogue, justice, freedom, security, economic cooperation, research, education, culture, trade, investment and energy. A "Partnership for Modernization" was launched in 2010. Negotiations for the visa facilitation agreement were concluded in 2011. However, Russia's intervention in Crimea led to the suspension of all these discussions and efforts. In 2014, the European Council decided to freeze cooperation with Russia. EU-Russia relations have been strained since 2014 due to the following causes: Russia's illegal annexation of Crimea, support for separatist groups in eastern Ukraine, destabilization policies in the neighborhood, disinformation and interference campaigns, and domestic human rights violations. Since 2012, when Russia joined the WTO, EU-Russia trade relations have also been governed by multilateral WTO rules. (European Parliament, 2024)

The EU reassessed its relations with Russia through the 2016 EU Global Security Strategy, defining them as "a key strategic challenge". In March 2016, the Council established five guiding principles to be applied in the EU's relations with Russia:

- (1) the implementation of the Minsk agreements on the conflict in eastern Ukraine, as an essential condition for any substantial change in the EU's position vis-à-vis Russia;
 - (2) strengthening relations with the EU's eastern partners and other neighbors, including those from Central Asia;
 - (3) increasing EU resilience (e.g. in energy security, hybrid threats or strategic communication);
 - (4) a selective cooperation with Russia on topics of interest to the EU;
 - (5) the need to make interpersonal contacts and support civil society in Russia.
- (European Parliament, 2024)

Since the large-scale invasion of Ukraine in February 2022, Russia has been considered an aggressor of Ukraine and the EU has reoriented its strategy towards the Russian Federation. In March 2022, the EU adopted the Strategic Compass for Security and Defense, recognizing that Russia poses "a direct and long-term threat to European security", thus marking a major shift in EU-Russia relations after 2016. This approach was supported and in NATO's Strategic Concept, adopted in June 2022, which states that "the Russian Federation represents the most significant and direct threat to the security of allies and to peace and stability in the Euro-Atlantic area". (European Parliament, 2024)

2.2 EU trade relations with Russia

Until February 24, 2022, Russia was one of the main trading partners of the European Union. Since 2014, Russia's illegal annexation of Crimea and its destabilizing role in eastern Ukraine have severely damaged EU-Russia relations. As a result, some political dialogues and cooperation mechanisms, including in the field of trade, have been suspended. Following Russia's invasion of Ukraine on February 24, 2022, the European Union adopted unprecedented measures aimed at significantly weakening Russia's economic base, depriving it of critical technologies and markets, thereby significantly reducing its ability to wage war.

In 2021, before recent trade sanctions began to take effect, according to (European Commission, 2024), in 2021 Russia was the EU's fifth largest trading partner, accounting for 5.8% of the EU's total merchandise trade EU with the whole world. In 2020, the EU was Russia's number one trading partner, accounting for 37.3% of the country's total merchandise trade with the world. 36.5% of Russia's imports come from the EU and 37.9% of its exports to the EU. In 2021, total trade in goods between the EU and Russia amounted to EUR 257.5 billion. EU imports were worth €158.5 billion and were dominated by fuels and mining products – mainly mineral fuels (€98.9 billion, 62%), wood (€3.16 billion, 2.0%), iron and steel (EUR 7.4 billion, 4.7 %) and fertilizers (EUR 1.78 billion, 1.1 %). EU exports in 2021 amounted to EUR 99.0 billion. These were led by machinery and equipment (€19.5 billion, 19.7%), motor vehicles (€8.95 billion, 9%), pharmaceuticals (€8.1 billion, 8.1%), equipment and electrical machinery (EUR 7.57 billion, 7.6 %) and plastics (EUR 4.38 billion, 4.3 %). Two-way trade in services between the EU and Russia in 2020 amounted to EUR 29.4 billion, with EU imports of services from Russia accounting for EUR 8.9 billion and exports of services to Russia accounting for EUR 20.5 billion. In 2019, the EU was the largest investor in Russia. The stock of EU foreign direct investment (FDI) in Russia amounted to EUR 311.4 billion, while the stock of Russian FDI in the EU was estimated at EUR 136 billion. (European Commission, 2024)

Regarding the current state of EU-Russia trade relations, in July 2014, in response to Russia's military intervention in Ukraine, the EU adopted a set of restrictive measures against Russia targeting four economic sectors: access to finance, arms, products with dual use and specific technologies for oil production and exploration. In August 2014, Russia reacted by introducing a political ban on imports of a range of agricultural and food products from the EU. The product definition was expanded in October 2017. In February 2022, following a new military aggression by Russia in Ukraine, the EU adopted additional sanctions targeting the energy, transport, technology and financial sectors, as well as imposing restrictive measures on natural persons. There are currently 13 sanctions packages in place (the latest – 23 February 2024). Trade with Russia is heavily restricted by EU sanctions. In addition, from 15 March 2022, the EU, together with the G7 countries and other like-minded partners, stopped treating Russia as the most favored nation in the WTO. This deprives Russia of its main trading advantages as a WTO member. (European Commission, 2024)

The main trade policy measures applied by the EU against Russia are:

- ✓ Arms embargo
- ✓ Ban on exports of:
 - Dual-use items and advanced technology products that can contribute to Russia's defense and security capabilities (e.g. quantum computers and advanced semiconductors, electronic components and software)
 - Goods that contribute to the strengthening of Russian industrial capabilities, including the energy industry
 - Transport equipment, goods used in aviation, space industry and maritime navigation

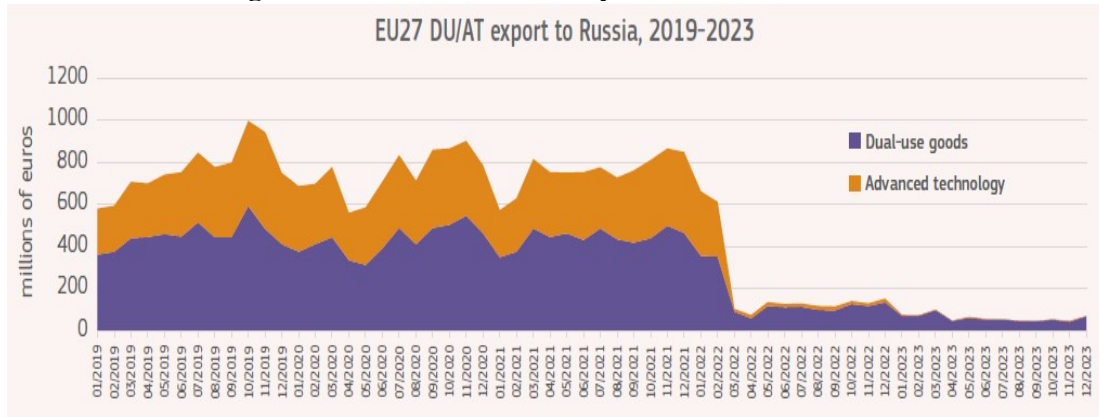
- Civilian firearms
- ✓ Prohibition of imports of:
 - Iron and steel, including some goods processed in third countries using Russian inputs
 - Cement, rubber products, timber, aluminum spirits, liquor, high-end seafood and other goods that generate significant income for Russia
 - Gold and diamonds
- ✓ Transit bans for certain goods prohibited on the territory of Russia
- ✓ Prohibition on providing technical support or brokerage services for prohibited goods, as well as selling, licensing, transferring or reporting intellectual property rights and trade secrets
- ✓ "Anti-circumvention instrument", which allows restrictions on the export of sanctioned goods to third countries with a continuing and particularly high risk of circumvention
- ✓ Operators' obligation to contractually prohibit the re-export of certain sanctioned goods
- ✓ Prohibition to provide certain services (business, legal consulting, IT consulting, etc.) (European Commission, 2024)(European Council, 2024)

2.3 The effects of the conflict in Ukraine on EU-Russia trade

Regarding the effects of the conflict in Ukraine on EU-Russia trade, EU restrictions on the export of dual-use and advanced technologies are designed to prevent Russia from obtaining the goods and technologies it needs to develop and produce weapons. By mid2023, trade in these technologies had fallen by more than 80% compared with pre-war levels (2019-2021). The remaining few exports of dual-use and advanced tech to Russia are allowed strictly and exclusively under exemptions and derogations e.g., for medical purposes, or (mostly) “grandfathered” existing projects in Russia. They are subject to assessment and authorisation by Member State authorities. The number and value of such these has steadily decreased over time, with only 9 recorded for the last quarter of 2023, worth less than EUR 1 million. (European Commission, 2024)

The most sensitive dual use and advanced tech items used in Russian military systems are so-called “battlefield items” or Common High-Priority (CHP) items. Thanks to the sanctions, their direct export practically stopped in 2023 (-97% compared to pre-war figures). However, as Russia keeps building illegal indirect conduits for these crucial items via third jurisdictions, sanctions enforcement and anti-circumvention efforts by the EU and Member States become ever more important.

Figure no. 2. EU27 DU/AT export to Russia, 2019-2023



Source: (European Commission, 2024), p.3

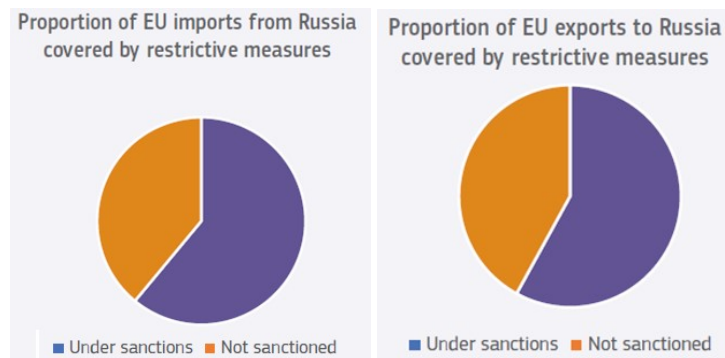
Figure no. 3. EU27 export of CHP items to Russia, 2019-2023



Source: (European Commission, 2024), p.3

The EU has imposed far-reaching import and export bans on trade with Russia, to deny Moscow’s war machine vital revenue, goods and technology. So far, 61 % of pre-war EU imports from Russia and 58 % of pre-war EU exports to Russia (both in 2021 terms) have been placed under EU restrictive measures.

Figure no. 4. Proportion of EU imports/exports from/to Russia covered by restrictive measures



Source: (European Commission, 2024), p.3

On the import side, the sanctions cover many high-revenue areas (coal, crude oil and refined oil products, wood, steel, processed metals and most recently diamonds).

On the export side, they target goods and technologies across a range of key sectors of Russia’s military-industrial complex (e.g. aviation, space, energy and maritime) and other goods which enhance Russian industrial capacities.

Total EU imports from Russia are down by 69 %, from a value of EUR 164 billion in 2021 to EUR 51 billion in 2023.

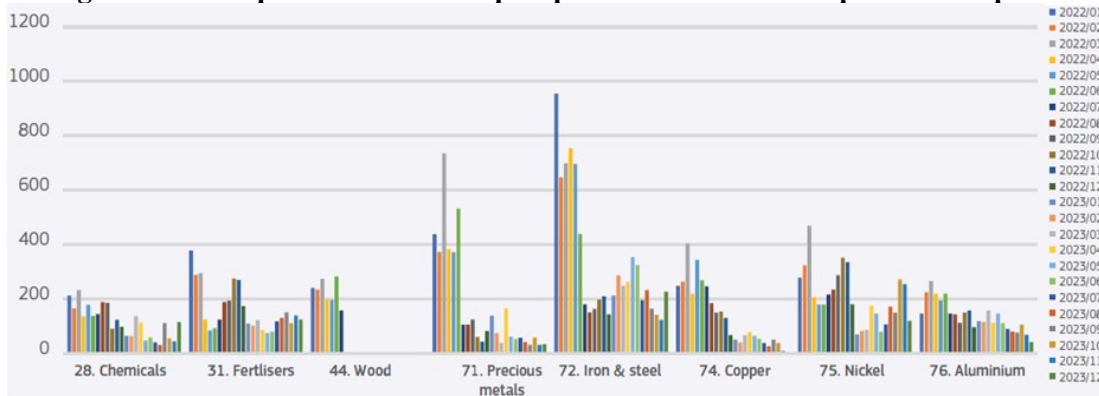
Figure no. 5. EU imports and exports to Russia, 2023 vs 2021



Source: (European Commission, 2024), p.4

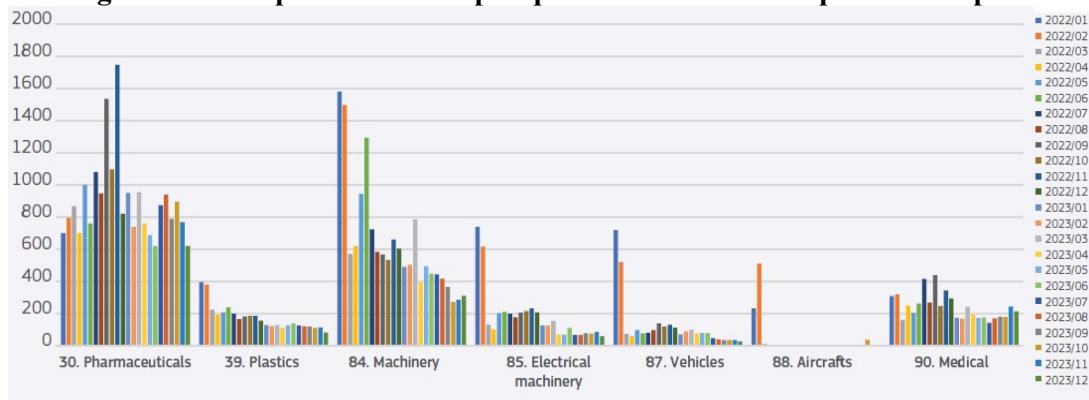
Total EU exports to Russia in 2023 clocked in at EUR 38 billion (down 57 % from 2021, EUR 89 billion).

Figure no. 6. Imports from Russia per quarter of selected HS product chapters



Source: (European Commission, 2024), p.4

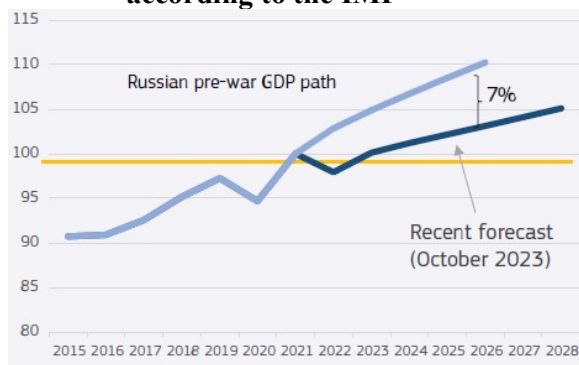
Figure no. 7. Exports to Russia per quarter of selected HS product chapter.



Source: (European Commission, 2024), p.4

Very limited access to Western technologies under the international sanctions, eroded human capital due to mobilisation and emigration, and massive military investments with little spillover to the civilian sectors will damage Russia’s economic potential over time.

Figure no. 8. War and sanctions have reduced Russia’s growth prospects according to the IMF



Source: (European Commission, 2024), p.1

According to the IMF, Russia’s economy remains 4.9% smaller in 2023 than the pre-war counterfactual and GDP growth is expected to slow to 1.1% in 2025. (European Commission, 2024)

3. Conclusions

Multilateral trade and multilateral institutions greatly amplify the trade-induced conflict reduction effect. In particular, evidence shows that multilateral trade and participation in trade networks reduce the likelihood of conflict. More diversified trade limits the risk of interstate hostilities and violent disputes because multilateral trade reduces potentially exploitable dependencies between economies. Furthermore, multilateral trade could greatly limit the conflict-generating role played by asymmetries, the main theoretical vector through which trade can promote conflict. Economies that participate in trade networks are less exposed to the conflict-inducing effects of asymmetric dependence because individual relationships matter less and therefore offer fewer opportunities for external coercion. In addition, multilateral trade creates incentives for third parties to act as intermediaries between conflicting parties. Conflicts undermine trade ties with third parties and create negative externalities for trading partners that maintain significant economic relations with the

belligerents. International organizations and trade agreements can contribute to peacebuilding; regional trade agreements may promote peaceful relations given the likely increase in the opportunity costs of war. By ensuring the predictability and transparency of trade, regional or multilateral international institutions such as the WTO stabilize international relations.

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