

Two futures: EU-Russia relations in the context of Ukraine.

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Abstract The enduring crisis in Ukraine presents the European Union (EU) with a conundrum. Should it strengthen its economic and energy ties despite Russia's growing assertiveness in the hope to solidify its medium term energy security and reel in Russian foreign policy? Or should it rather continue to tighten the screws on the Putin regime, in the hope that doing so will concurrently compel the Russian Federation to moderate its behaviour? This paper argues that it is not prudent for the EU to decrease cooperation with Russia in the short term, but rather push for a political solution without additional sanctions and in the long-term secure different fossil resources such as LNG and different suppliers such as Iraq and Iran. Whichever way the EU chooses, Ukraine's role in EU energy security is depreciating. Nevertheless, the EU possesses a stronger bargaining position than widely believed because Russia lacks a credible alternative to European foreign direct investments (FDI). The EU should (1) establish an energy union that includes gas storage and distribution plans and extends the Energy Community to include Turkey to pave the way for future gas flows; (2) support infrastructure projects that increase reverse flow capacities within the EU as well as South Stream or its heirs and the Southern Corridor via

Turkey to enhance import capacity; and (3) massively invest into energy research.

Keywords Ukraine · Russia · Energy union · South stream

The enduring crisis in Ukraine presents the European Union (EU) with a conundrum about the future of EU-Russian relations, a choice of preference about two very different futures. Should it move to strengthen its economic and particularly its energy ties to Russia despite its growing assertiveness in Ukraine and its near abroad in the hope that doing so will strengthen its medium term energy security and reel in Russian foreign policy? Or should it rather tighten the screws on the Putin regime, as it is currently doing, in hopes that this will concurrently compel the Russian Federation to moderate its increasingly assertive foreign policy and anchor Ukraine tightly into the Western fold?

The choice is not necessarily an easy one. Europe is divided on the importance of Russia's role in European energy security. For example, Russian gas is more important for Germany and Italy than it is for France and the UK. Yet even if one assumes that the Union actually could decrease its gas cooperation with Russia in the near term, and thus move now to mitigate future gas interruptions, one has to ask whether it is in the long-term interest of the EU to reduce, let alone break, a trade relationship that has profited both neighbours for decades. The choices made now will have serious consequences in the future. As the Economist recently observed, it is certainly possible to reduce Europe's dependence on Russian gas, "but it will take time, money and sustained political will" [1]. Whichever direction Europe chooses, there will be serious consequences for the future of EU-Russian relations as well as the costs of European energy bills.

The view one has depends to a large extent on one's assumptions about the strength of Europe's negotiating

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position, Russia's intentions in its near abroad, its reliability as a supplier, and the notion of whether an economically strong or weak Russia is good or bad for EU strategic interests. While the EU's position is far from strong, it is not weak. While the EU still lacks a short or medium term alternative to Russian gas, Russia equally lacks a credible alternative to European foreign direct investments (FDI) and that gives the EU's bargaining position more teeth than one might initially think. Moscow's recently concluded 30-year, \$400 billion deal to pipe natural gas from Russia's Far East to China [2,3] is not a game changer because it averages out to less than €13,5 billion per year in revenue; and while Russia appears to earn more per thousand cubic meters (\$350/€274) [4] than it earned from European customers (€229) in 2013, the relatively low volume appears more designed to enhance Russian export security alongside rather than to replace Europe as a consumer.

Beyond the punditry and rhetoric, Russia has proven to be a reliable supplier since it began delivering gas to Western Europe in the late 1960s. A move to break that partnership over Ukraine may be popular, but is it prudent? Will it benefit Europe's interests in the short to medium term? Russian gas is still cheaper than imported liquefied natural gas (LNG). Indeed, some have suggested that UK prices would have to double to make LNG attractive [5] and the US does not appear ready to export massive amounts anytime in the near term; and if it did, there is little economic reason for its exports not to go to Asia where prices are higher. Meanwhile, domestic hydraulic fracturing (fracking) is not likely to offer respite in the near term and certainly will not enhance solidarity as witnessed by the heated debate between the member states about its economic viability and environmental sustainability.

A complete or even substantial shift away from Russian gas supplies will not reduce the geopolitical risks that Europe faces along its eastern border. Indeed, freed from the constraints of having to balance its financial and political interests vis-à-vis Brussels and barring a sea change in European attitudes toward hostile military engagements, Moscow would be free to implement any political order it sees fit throughout its historic geographic buffer zone. Thus, this article argues that it is not in the EU's interest to decrease cooperation with Russia in the short term, but rather to work toward deepening that relationship; to incorporate rather than confront. It proceeds with an analysis of Ukraine's depreciating role in EU energy security and the EU-Russia trade relationship followed by a brief exploration of two possible futures in the relationship between Brussels and Moscow and concludes with policy guidance.

The shrinking reliance on Ukraine as a transit state

The threat perception in the context of the 2014 Ukrainian crisis reflects the painful experiences of the 2009 gas crisis

between Russia and Ukraine when 80 % of gas intended for Europe had to transit the latter. That crisis affected many EU member states, when in the middle of a cold winter the supplies through Ukraine were interrupted for 2 weeks. Since then the situation has changed. The Nord Stream Pipelines (in operation since 2011) now directly link Russia and Germany and, together with warmer winters and a recessed economy that dampened demand, has reduced significantly the annual gas flows transiting Ukraine. According to the Oxford Energy Institute, Russia now relies on Ukraine to transit circa half of its gas exports to Europe [6], a change that also reduces the threat that Kiev's siphoning of gas, which it did in 2009, could disrupt Russian supplies.

Bringing projects like South Stream or its heirs online will further reduce that dependency. South Stream is a Gazprom led project with major EU shareholders, planned for completion by 2020 that could provide 63 bcm (billion cubic metres) of Russian controlled gas directly to the EU. The future of the pipeline was thrown into limbo when Russian President Vladimir Putin suddenly announced Russia's withdrawal from the project in early December and proposed alternatively to send gas to Turkey and build a hub on the Turkey-Greek border. Nevertheless, if Nord Stream and a southern route sibling are operating at full capacity by 2020 and EU annual demand for Russian gas continues to stagnate or even decline via increased efficiency or through the introduction of new suppliers, the share of Ukrainian transited gas could drop as low as 20 %.

There is no mystery to what is happening here. Russia is seeking new pipelines to bypass Ukraine. Direct deliveries to Europe make it easier for Moscow to guarantee gas flows to Europe in return for vital revenues, a cornerstone of Russia's energy security strategy. Nord Stream was the first step in this direction. It would be delivering much more gas to Europe if the European Commission would lift its objections to Gazprom's use of its Ostsee-Pipeline-Anbindungsleitung (OPAL), which could deliver Nord Stream's gas to central Europe. Those restrictions essentially cut Nord Stream's 55 bcm throughput capacity in half.

For Russia, South Stream or any southern-route alternative is thus the next logical step. Some analysts suggest that it is cheaper for Moscow to build South Stream rather than to keep the transit routes through Ukraine [7]. From the EU's perspective, the real question is whether it matters if Russian gas flows through Ukraine or through a new pipeline that is largely under its control until it reaches the border of the EU. Either way Moscow will continue to supply large volumes of gas to the EU in the medium term; that is for the next 8–9 years when several of the major existing long-term gas supply contracts (LTCs) run out. It is precisely within this time frame of the coming decade where European energy security can make a quantum leap forward. While LNG cannot replace piped Russian gas today, the market may mature enough by 2020–25 to offer a real alternative just at the time when new negotiations with Russia will be in full swing. Currently, EU LNG import capacity is

around 192 bcm per year including Turkey's two terminals. Add another 5 terminals under construction and 16 in the planning stage and Europe could be able to import as much as 315 bcm by the time new long-term contracts are necessary.

Right now LNG is not an option. It is too expensive in comparison to Russian gas largely because Japan has been paying a premium to make up for its shortfall in nuclear power following the Fukushima disaster. Yet new gasification facilities are coming online along the Atlantic basin. Where LNG amounted to less than 10 % of the world trade in gas 20 years ago it now stands at over 30 % of all gas traded worldwide. Germany and Italy, the EU's first and third largest gas markets are both planning new LNG facilities and the US is widely expected to begin exporting LNG at scale around 2018. Growing by circa four percent annually, BP expects the global trade in LNG to rise to as much as 46 % by 2035 [8]. Russia is investing (together with the UK's BP) in LNG export options that will capitalize on increased Japanese demand, which eventually will alleviate the market by reducing demand from distant suppliers freeing up LNG supplies at lower prices for Europe. One example of the future importance of LNG can be witnessed today in Lithuania, which opened a new LNG terminal in its Baltic Sea port of Klaipeda in late October. The leased terminal will allow Vilnius to buy 540 mcm of gas from the Norway's Statoil as of early 2015 and then up to 4 bcm per year once the Baltic nation's deal with Gazprom expires in late 2015. Its 4 bcm capacity more than covers all the gas supplied by Russian pipelines to Lithuania in the past and substantially enhances the energy security of the three Baltic states with a capacity to cover 90 % of their annual gas needs [9]. In short, the EU can wait out the current crisis, stabilize direct flows of Russian gas and allow the LNG market to settle such that in 10 years it can look forward to a more stable international gas supply market, one in which perhaps consumers and not suppliers will set prices.

None of this bodes particularly well for Ukraine. In the long run, Russia's new supply routes to Europe are freeing up time and resources for the EU to maximize returns resulting from structural changes in the international gas market. Thus, no matter how one looks at it, Ukraine is declining in importance for EU energy security. Whether losing the transit rents will make Ukraine more or less stable in the future is difficult to assess at this point. It may be that cutting Ukraine out of the EU's energy dependency chain will shift too much political power to Russia. Thinking so, however, rests on the assumption that the EU needs Russia more than vice-versa, which we show below to be a misinterpretation of the constellation between the two powers.

The EU-Russian economic relationship – a story of interdependence

One of the major arguments in the debate over the EU's energy relationship with Russia is the assumption that high levels of

economic interdependence between states decrease the probability of political conflict. Empirical studies show how that process functions under conditions of balanced interdependence and how when one side is more dependent on the other, the probability of the conflict increases [10–12]. What exactly is the state of the EU-Russia trade balance? Is it really incompatible with a stable and balanced relationship? In the EU-Russia context, the EU depends on oil and gas imports from Russia. But because it lacks a strong industrial sector, Russia depends on oil and gas revenues. Thus, even though the EU will need Russian energy supplies for the foreseeable future, unless it finds a substantial and sustainable alternative suitor, Russia will desperately need continued EU investment for its stagnating economy. In short, Moscow needs the EU as an export market for its energy products as much as it needs European goods, services, and FDI to keep functioning economically.

According to the European Commission [13], Russia is the EU's third largest trading partner. While Russia exports raw materials to the EU (mostly crude and refined oil and gas), the EU supplies Russia with a diverse array of machinery, transport equipment, chemicals, pharmaceuticals and agricultural products. This translated into an €86.7 billion trade advantage for Russia in goods in 2013, but the EU exported twice as much in terms of services (€29.1 to €15.1 billion) in 2012 and held a surplus of FDI, that is stock investments, of over €112 billion. Indeed, some 75 % of Foreign Direct Investment in Russia originates from the EU making Russia proverbially married economically to the EU.

In addition to FDI, many EU member states export a significant share of industrial goods to Russia. Approximately 47 % of all EU exports to Russia in 2013 were in the form of machinery and transport equipment, essential products for infrastructure development and economic growth. If one calculates European investments in Russia into the trade picture, Moscow does not come out the dominant player (see Table 1).

Germany provides a good example of EU-Russian interdependence. Germany exported over €76 billion to Russia in 2013; a decline of five percent off the previous year. By

Table 1 The EU's trade balance with Russia (in €billions)

	2011	2012	2013
Goods	-92,7	-91,7	-86,7
Services	9,9	14,1	n/a
FDI	112,2	112,9	n/a
Balance	29,4	35,3	

Source: The European Commission

Source: <http://ec.europa.eu/trade/policy/countries-and-regions/countries/russia/>

Source: http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113440.pdf

Source: http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_111720.pdf

comparison it exported €88 billion to the US and over €100 billion to France. Its overall trade deficit with Russia in 2013 was less than €5 billion, and almost all of Moscow's imports came in the form of oil and gas. In other words, even a slight reduction in German imports of Russian gas could bring them in perfect balance in terms of goods; and that is excluding German FDI in Russia, which was almost €16 billion in 2013. Germany's biggest concern, therefore, is not a Russian cut-off of energy supplies. The latter has been a reliable supplier for decades. Rather, it is that economic stagnation or even decline in Russia would hurt German export revenues. While decreasing energy imports from Russia might endanger some EU exports (assuming that demand declines for high quality European and particularly German goods or that Russians buy these goods elsewhere), it is certainly not likely given how important such goods are to Russian economic development.

Meanwhile, Russia's steadily increasing share of the EU energy market via its state dominated gas giant Gazprom is as much a sign of opportunity as it is risk for the Union. Gazprom currently holds shares of nine major Transmission System Operators (TSO) in eight EU member states (see Table 2), but has a controlling share in only two cases. Instead of endangering European energy security, those investments create opportunities to subject Russian business practices to EU norms and lock Russia's economic fate to that of the Union.

One would be remiss not to consider this essential bond between Russia and the EU. For the foreseeable future, neither has viable alternative to cooperation. Whether it likes it or not, the EU needs a reliable energy supplier with a stable economy for investments and exports. And Russia needs a reliable partner. The EU could capitalize on this existing interdependence by offering Moscow increased rather than reduced investments in its energy sector, which in turn would foster continued export of cheap gas and oil to Europe and increased LNG to Japan and the Asian market, laying the foundation for enhanced long-term energy security for both parties.

Table 2 Gazprom shares in the EU energy companies

Country	Company	Gazprom's share in EU TSOs
Bulgaria	Overgas Inc.	0.49 % OAO Gazprom
		49.51 % OOO Gazprom Export
Estonia	Eesti Gaas	6.38 %
Finland	Gasum Oy	25 %
Germany	Wingas GmbH	100 %
Latvia	Latvijas Gaze	34 %
Lithuania	Amber Grid (AB)	37.1 %
		Lietuvos Dujos
Poland	EuRoPol Gaz	48 %
UK	(UK) LIMITED	10 %

Source: Authors based on Gazprom public records

Two futures

The preceding analysis infers two possible futures for EU-Russian relations. On one hand, the EU could take the current Ukraine crisis as the impetus to reset its relationship with Russia by making any future investments in its energy sector as well as Russian investment in the EU contingent upon an EU-favourable solution in Ukraine. In this future, the EU would move rapidly to divest from Russia, accepting higher gas prices and increasing its use of coal to offset the resulting economic cost, in order to win the political and moral high ground (at the cost of its environmental goals) in the short term with the hope of achieving greater energy independence in the long run. On the other hand, the EU could deepen its relationship with Russia by increasing its FDI in the latter's gas and oil sectors, and accept Russian interests in its near abroad at the cost of Ukrainian sovereignty with the hope that doing so will establish common ground for a long-term economic and political stability between the two neighbours. In this future, Eastern Ukraine becomes a de facto protectorate of Moscow bordering on a West Ukraine that adheres to the energy acquis and South Stream or its successor delivers over 60 bcm annually to South, Central and Eastern Europe for decades to come. The future thus depends on a strategic choice between confrontation and accommodation and Moscow cannot be expected to make it an easy one.

The fact is that Russian President Vladimir Putin's vision of a resurgent Russia is tied to state control of energy resources at home and abroad [14], a policy approach that is directly at odds with the EU's open market ideals. Seen in the light of Putin's grand plan to "have a large impact on the world commodities market" [14: p.51], Russia's concerns about EU diplomatic efforts to export common rules rooted in the EU's energy acquis, its neighbourhood policy, its seemingly unstoppable enlargement process, its attempts to meddle in the political affairs of Ukraine and Georgia, and its efforts to bypass Russia in accessing Caspian Littoral resources take on added meaning. These areas are not only historically central to Russian security thinking, they also are an essential part of the country's national energy export infrastructure and, thus, an indispensable component of Russian capability to project economic power.

Russia knows that East and Southeast Europe constitute the EU's contemporary energy lifeline and its main choke point. When it seized the Crimea in March 2014, the largest importer of Russian gas, Germany, did little more than offer tough talk. As Donald Tusk, the prime minister of Poland tersely noted at the time, "Germany's reliance on Russian gas can effectively limit European sovereignty" [15]. For Moscow and its strategy to keep its gas flowing to Europe and the latter's money flowing back to Moscow, Ukraine's vacillating orientation between east and west is unacceptable and Russia is rightly concerned about the spill over effects caused by domestic

instability in Ukraine and Belarus. Its southern borders are porous at best, and the 2004 Orange Revolution and 2014 ouster of pro-Russian President Yanukovich in Ukraine reminded Moscow of the vulnerable nature of the countries along its periphery. The EU's efforts to negotiate an association agreement with Kiev directly challenged Russia's so-called sphere of influence and exacerbated Russian concerns about EU intentions. Given the constellation of powers and interests in East and Southeast Europe, there should be little wonder why Russia is seeking alternative energy transit routes around Ukraine. Since the region around Ukraine also serves as a possible future transit route for Caspian and Central Eurasian energy resources destined for the EU, Europe certainly can expect heightened tensions with Russia over everything from pipeline routes to election monitoring.

For the EU to secure its short and medium term energy needs, it may need to placate Russian concerns and cater to Moscow's demands for regional domination and neighbourly suzerainty. Doing this, however, runs contrary to Brussels' political leanings and interests. Clearly, Europe needs a strategy to deal with its massive Eastern neighbour and energy supplier. Public declarations to reduce dependency on Russia are not going to convince Moscow to loosen its grip on the Eastern European transit states. In fact, it may cause the opposite effect, with the additional detriment of dividing the Union.

Finding an alternative to Russian oil and gas is not just a principle problem for Brussels. It is a matter of practicality and prudence. Europe faces more competition for energy resources in Central Eurasia than anywhere else in the world. Both China and Russia straddle the region. The EU does not. Therefore, in order to secure the region's oil or gas, either Brussels or a collection of EU based companies will have to spend a fortune and do so almost entirely on local terms. Even if Europe were ultimately to succeed in landing contracts and building pipelines, the EU will find itself at a distinct disadvantage in Central Eurasia. Russia is without question the region's dominant military and economic power. It has demonstrated its capability and will to secure its interests across the region repeatedly over the last two centuries and remains the primary trading partner for all of the former Soviet Republics.

That is where Ukraine comes back into the picture because that is where the future of the Russia-EU relationship is being tested. Establishing economic and political stability in Ukraine and integrating the latter into both markets is essential for Europe. Brussels cannot politically afford to allow Russia to subsume Ukraine. But Europe should not overplay its cards. Eastern Ukraine's importance to Russia goes beyond national identities. The former hosts factories and expertise for key components of the latter's nuclear and ballistic missile forces. Thus, Russia and the EU need to reach a settlement over the future of Ukraine that incorporates its decreasing role in their

energy relationship and takes into context the complex interdependent nature of the EU-Russian relationship and the legacies of the Cold War. The benefits of doing so far outweigh the costs associated with downgrading their energy relationship. To be certain, the EU should be concerned about the future of the eastern European neighbourhood and should work to prevent a major shift of power towards Russia. However, focusing on short term strategies to diversify suppliers and challenging Russia rather than deepening its already existing cooperative trade and investment relationship will come at a price for European energy consumers that most are not prepared to pay. Either way, Ukraine will be squeezed out of the energy equation.

Next steps

So what should Europe do in regard to its energy relationship with Russia in light of Ukraine crisis? The European Commission (May 2014) [16] suggests continuing with its planned infrastructure programs, internal market policies, and increasing shares of renewables. That is simply not enough. Nor is downgrading the energy relationship with Russia in the hope that it will in any manner increase the EU's influence over the future of Ukraine or affect Russian interests in its near abroad. Rashly breaking off interdependencies in the short term could concurrently lead to more aggressive policies by Russia and its state dominated corporate energy agents and bring higher gas prices to EU consumers. Conversely, deeper relations will afford the EU the opportunity to maximize its influence over Russian policy in Eastern and Central Europe and the Caspian Littoral, induce Moscow to reform its economy, and win time both to develop domestic gas and renewables at home and for international LNG prices to come down. In this vein, we suggest three specific courses of action.

First, the EU should push to establish an energy union comprising *inter alia* a large scale joint R&D program to improve existing renewable technology, a transparent joint fossil resource management system, a transparent system of gas storage facilities and emergency distribution plans, a joint management of intermittency problems, and subsidies for gas in order to curb the increasing use of cheap coal. Such a union could significantly improve relations with Russia and increase the EU bargaining power in the medium to long term. Likewise, the EU should make a serious push to deepen the energy relationship with Ankara by extending the existing Energy Community to Turkey and thus pave the way for future gas flows resulting from a rapprochement between Iran and the West and the coming flows of Israeli/Cypriot gas.

In a sign that Jean-Claude Juncker and his team are all in on bringing about the formalization of a European energy union, the new head of DG energy, Maroš Šefčovič, now carries the apt title Vice President for Energy Union. Although symbolic,

such a development is a good sign. However, any future energy union should avoid the controversial single buyer model as proposed by Polish Prime Minister Tusk [17]. Despite the fact that some member states already operate the single buyer model (e.g. the National Balancing Point in the UK and Title Transfer Facility in the Netherlands), such a move at the community level would task the Commission to negotiate gas contracts on behalf of the EU. While this would unite EU purchasing power, it also would make the Commission a central commodity manager that sets prices. In other words, it would bring back the public utility model of the 1970s – i.e. a regulated market without competition – something that the EU struggled so long and hard to liberalize. As one energy expert sharply noted, such a move makes “no economic or commercial sense”, but instead amounts to “political posturing” rather than a serious policy proposal [18].

Second, the EU should back the building of new import infrastructure projects. This requires supporting South Stream or its heirs and making a major investment in the Southern Corridor including large volume pipelines transiting Turkey to its eastern borders and southeastern Mediterranean coast. It also means increasing the reverse flow capacities within the EU. The EU’s only alternative to cheap gas right now is cheaper coal, which is a veritable disaster for EU environmental policy. Meanwhile, Russia has the gas that the EU needs now and European firms have made substantial investments in South Stream. The EU also has the internal network to move gas north or south. Allowing Nord Stream to fill OPAL could immediately maximize Germany’s import capacity and alleviate some of the legitimate concerns about winter supplies if the Ukrainian crisis continues unabated.

Currently, most EU states support South Stream despite the difficulty with Moscow, but some members of the European Parliament are raising concerns. Those concerns need to be addressed and Europe needs to move forward. With Crimea firmly in its hands, Russia soon will be able to move gas via South Stream or its successor directly to the EU’s southeastern member states, a la Nord Stream. Because a southern diversion has the potential to significantly decrease the importance of Ukraine as a transit country, it will enhance the EU’s security of supply while affording Brussels the time necessary for the international gas market to turn in the EU’s favour, an opportunity that should not be missed. But if the EU really wants to consider liberating itself from Russian gas, the biggest prize will not be South Stream, but rather Iraqi and Iranian gas, neither of which will flow en masse in the next few years. By itself that is not a problem because it will take at least 5 years, if not ten, to get the infrastructure in place to deliver that gas. Europe needs to begin building the pipelines capable of delivering that gas now.

Third, the EU has to put massive investments into energy research. Currently, the efficiency of renewable energy sources is rather modest and the intermittency problem remains unsolved. If Europe wants to stay committed to its

climate goals in all its manifold iterations, it must significantly intensify its efforts in this area. While the EU is spending considerable amounts on nuclear fusion research projects (e.g. ITER) other highly important fields need more attention ranging from energy storage to biomass, from increasing energy efficiency in order to achieve energy savings to the economically viable reduction of emissions.

Whether or not Ukraine’s descent into EU energy security inconsequence is good or bad for Europe depends on which outcome is more important. Reliance on Russian gas is not necessarily a bad thing if its supply is reliable, cheap and free of expensive political payoffs such as further expansionist gains or the rise of a vast non-liberal market to the east. Yet as Nord Stream demonstrates, Russia and EU energy companies value reliable long-term direct links over transit options, even if the initial investment costs seem prohibitive. South Stream or any alternative southern detour may not be the most profitable in the short run, but it will absolve Russia from the threat of a transit state siphoning off its gas to Europe, and that is certainly in the interest both parties. In the short to medium term this could make the EU concurrently more reliant on cheap Russian gas, more secure in its supply, and put it back on track to cut out its uncomfortable dependence on coal. In the long run, it frees up time and resources to maximize return resulting from structural changes in the international gas market. Breaking the EU’s energy and trade relationship with Russia over Ukraine may seem to some to be the right ‘feel good’ thing to do here and now. But completely eliminating it is neither politically nor economically prudent.

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