ECONOMIC SANCTIONS BETWEEN THE EUROPEAN UNION AND THE RUSSIAN FEDERATION & QUI BONO?

Lenka Fojtíková [1]

Abstract

While during peacetime countries cooperate and trade, at times of war they use different barriers to trade. A war usually has political reasons, but economic consequences. This paper focuses on the current European Union (EU)-Russian trade and economic relations, which were influenced by reciprocally imposed economic sanctions due to the war in Ukraine. The aim of the paper is to evaluate the impact of economic sanctions on the EU-Russia bilateral trade, and to discuss the consequences of the current restrictive measures on both economies. Besides the analysis of trade data, different sources of literature are explored. The results of our examination show no trade war has an immediate winner. The EU's import substitution policy will be carried out at high costs, which taxpayers will have to pay for many years. It will also be a test of the EU's integrity and solidarity between its member states.

Keywords

European Union, External Trade, Import Substitution Policy, Protectionism, Russia, Sanctions

I. Introduction

After the disintegration of the Soviet Union in December 1991, the Russian Federation was one of fifteen Post-Soviet Union states with many economic and social problems, which accompanied Russia during its economic transformation in the 1990s. Besides economic reforms and the privatisation of a predominant part of the state estate, external relations with new partners abroad were developed as well. Thus, the political and economic relations between Russia and the European Union (EU) have been based on a bilateral Partnership and Cooperation Agreement since 1997. In the trade sections the agreement was aimed to promote trade and investment, as well as develop mutually beneficial economic relations. On this base the EU imported from Russia the necessary fuels and raw materials needed for its final production (Fojtíková, 2013) and shared in the total Russian exports by one third. This means that the EU as Russia's largest trade partner was for Russia an important source of money, but also of investments and technology for many years, although the agreement was signed only for 10 years, i.e. until 2007. Negotiations for a new EU-Russia Agreement started in 2008, but they were put on hold in 2010 due to lack of progress in the Trade and Investment Chapter. Besides this, the EU supported Russia in its entrance into the World Trade Organization (WTO), which occurred in 2012 after a long 18 years of bilateral and multilateral negotiations.

Reciprocally advantageous economic cooperation between Russia and the EU was disturbed several times by trade disputes and political incidents at the beginning of the 21st century, such as the annexation of Crimea by Russia in 2014 and its military intervention in Ukraine in 2022. However, Russia remained the fifth largest trade partner of the EU in 2021. Thus, the paper aims to evaluate the impact of the economic sanctions that have been imposed reciprocally by the EU and Russia on the EU-Russia bilateral trade, and to discuss the consequences of the current restrictive measures on both economies. As the predominant part of the EU-Russia bilateral trade is carried out in goods (i.e. about 258 billion euros amounted to trade in goods and 29 billion euros amounted to trade in services in 2021), the paper only focuses on data that cover merchandise trade.

[1] PRIGO University, Vítězslava Nezvala 801/1, Havířov, Czechia. E-mail: lenka.fojtikova@prigo.cz

Firstly, a view on the economic sanctions in empirical literature from different perspectives is provided. Secondly, the economic sanctions that were imposed by the EU and Russia on their bilateral trade is described. Thirdly, the evaluation of the impact of the economic sanctions on the EU-Russia bilateral trade is introduced and other economic consequences are discussed. The conclusion summarises the main facts and shows the direction in which a serious analysis could be continued in the future.

II. Economic Sanctions in Empirical Literature

From the economic point of view, sanctions restrict international trade flows, creating rents for import-competing producers, who are protected from international competition. These rents can then be used to pressure the government to implement protectionist policies. Thus, sanctions create powerful domestic interest groups in the sanctioned country which seek market protection (Pond, 2017). History confirms that economic sanctions have been used as a tool of war (The Conversation.com, 2022) or another view is that they represent a liberal alternative to war (Bezuidenhout et al., 2019). Economic sanctions are the weapons of the rich and powerful (Jones, 2016). Sanctions are measures by which a country can respond to political challenges and developments that are contrary to its goals and values (Kochajdova, 2018). Thus, economic sanctions usually have a political rationale, but an economic impact. According to Filipenko et al. (2017), economic sanctions demonstrate how the individual countries, and regional and international organisations react to huge violations of human rights, the sovereignty of countries, and international law in general.

In connection with economic sanctions, many authors focus on Russia. Silva and Selden (2020) test the hypothesis that the EU member states that are more economically interdependent with Russia would be the most opposed to the imposition of sanctions on Russia in response to its actions in Ukraine in 2013/2014. However, their analysis shows the opposite. Thus, the Post-Soviet Union states, although more dependent on the Russian supplies of fuels than the EU West countries, usually have a negative political stance towards Russia, which exceeded their economic interests. Korhonen (2021) states that the sanctions imposed on Russia had an effect on the country’s foreign trade and on the inflow of direct investments, but even more than the sanctions the fluctuations in the price of oil had a far greater influence on Russia’s economy. Li and Li (2022) analyse the relationship between the economic sanctions and regional differences within Russia from three perspectives, i.e. regional favouritism of the political elites, industry development, and trade costs. They found a correlation between the economic sanctions and regional differences. For example, areas close to the Chinese border were relatively more economically active. However, the results of some empirical studies were simplified. For example, Coufalová (2020) explores the impact of the economic sanctions imposed on the Russian Federation by most of the Western countries on the Czech exports from 2000 to 2017. Although the results of her gravity model led to the conclusion that the economic sanctions had no significant effect on the global Czech exports to Russia (Coufalová, 2020), some shortages of this conclusion are obvious. Besides a lot of variables in the model, which have an immediate effect on trade, the econometrical model did not consider additional factors, such as the growing competition in the EU market that occurred due to the Russian retaliations, which had a negative impact on the Czech economy and trade as well. In contrast, Santalova (2018) considers all aspects of the sanctions which were imposed against Russia by the governments of the USA, EU and some other countries in 2014-2016. This means that not only the companies included in the sanction lists suffered, but also other Russian companies faced negative consequences.

Another issue is that sanctions do not only harm the nation against whom they are aimed, but they have different consequences across the globe. Silva and Selden state (2020) that economic sanctions impose costs on the sender as well as the target states, and those costs increase with the degree of interdependence between the states in question. Thus, the negative effect of economic sanctions is obvious especially now, when the world becomes increasingly interconnected and interdependent.

Vorotnikov et al. (2019) also state that the global economy is so closely linked to the economic, political and social interests of countries that conceivably it becomes impossible to create operating conditions for the existence of an autarkic economy, and this obviously negates the consequences of imposed sanctions.

III. Economic Sanctions between the European Union and Russia

Article 2 of the Lisbon Treaty sets the aim of the European Union, such as to "*promote peace, its values and well-being of its people"*, and in its relation with the wider world the EU will "*contribute to peace, security, the sustainable development of the Earth, solidarity and mutual respect among peoples, free and fair trade, eradication of poverty and the protection of human rights"*, etc. as well as *"observance of international law, including respect for the principles of the United Nations Charter"* (Official Journal of the European Union, 2007). However, as practice confirms, **free trade has been damaged several times by economic sanctions**, which the EU imposed, among other things, on Russia in response to Russia's invasion of Ukraine. With respect to Article 188 C of the Treaty of Lisbon that *"common commercial policy shall be conducted in the context of the principles and objectives of the Union's external action"* (Official Journal of the European Union, 2007), the economic or trade interests are, thus, submitted to external political objectives. As the EU member states accepted, upon their entrance into the EU, the common commercial policy, which is based on the common principles, the decisions in the trade area enacted by the Council of the European Union and the European Parliament are uniform for all EU27 member states.

Since 2014, the EU leaders have gradually adopted several restrictive measures aimed at Russia, which led to worsening EU-Russia bilateral relations. Due to the illegal annexation of Crimea and Sevastopol by Russia, the EU imposed these restrictive measures:

- Prohibitions targeting the imports of products originating from Crimea or Sevastopol into the EU;
- Infrastructural or financial investments and tourism services from Crimea and Sevastopol;
- The exports of certain goods and technologies to Crimean companies or for use in the illegally annexed Crimea in the transport, telecommunications and energy sectors;
- The prospection for and exploration and production of oil, gas and mineral resources (European Council, Council of the European Union, 2022).

The economic sanctions were imposed in 2014, but the Council of the European Union decided to extend these sanctions several times, most recently on 20 June with the application until 23 June 2023 (European Council, Council of the European Union, 2022). In retaliation to the EU's measures, the Russian government also imposed a ban on the import of some agricultural products and foodstuffs from countries which imposed restrictive measures on Russia, and later a ban on the import of some engineering products (Fojtíková, Vahalík, 2015).

Another impulse for the adoption of new sanction measures on Russia was its military aggression against Ukraine in the Donetsk and Luhansk areas in February 2022. In response to Russia's continuing war in Ukraine, on 3 June 2022 the EU adopted a sixth package of sanctions, which includes:

- A ban on the imports of crude oil and refined petroleum products from Russia, with limited exceptions;
- A SWIFT ban for an additional three Russian banks and one Belarusian bank;
- The suspension of broadcasting in the EU for three more Russian state-owned outlets.

The EU's export and import restrictions on Russia mean that European entities cannot sell certain products to Russia and that Russian entities are not allowed to sell certain products to the EU market. However, this protectionism will have destructive effects on business and public finance on both sides of the barricade. As the 2014 sanctions were focused namely on subjects operating in Crimea and Sevastopol, the current measures cover different subjects and areas of the Russian economy. On the one hand, the Russian economy records a high level of product concentration (the value of the Concentration Index was 0.265 in 2020, while the world average was 0.063, see UNCTADStat, 2021), with a high share of fuels in Russian exports (petroleum oil, gases and coal account for almost half of the Russian exports, see WTO, 2022), which contributes to its dependence on energy exports. Thus, the EU expects that the restrictions imposed on the Russian energy export will significantly reduce Russia's trade profits (European Council, Council of the European Union, 2022). On the other hand, the Russian economy is less dependent on foreign trade than the EU economy, i.e. while the exports of goods and services accounted for about 31% of the Russian GDP, it was almost 51% of the EU's GDP in 2021. This difference between the Russian and the EU economy is even more obvious on the import side, where the imports of goods and services account for about 21% of the Russian GDP, but almost 47% of the EU's GDP (The World Bank, 2022).

Overall, the EU measures include individual sanctions, economic sanctions, restrictions on media and diplomatic measures. Since 2014, the EU has also sanctioned 98 entities and 1,158 individuals, such as Russia's President Vladimir Putin, Russia's Minister for Foreign Affairs Sergey Lavrov, some members of the Russian State Duma, the National Security Council, prominent businesspeople and oligarchs, etc. (European Council, Council of the European Union, 2022).

Besides the EU's economic sanctions, the EU, in cooperation with other countries of the G7 Group (Great Britain, Canada, France, Germany, Italy, Japan, and the USA), has adopted a statement giving the right to stop treating Russia as a most-favoured nation (MFN) within the WTO framework. Taking Russia away from the MFN treatment enables the USA and its like-minded partners to increase tariffs on different Russian products (Deník.cz, 2022). However, Russia is a member of free trade zones, such as the Common Economic Zone or the Euroasian Economic Union. Russia has also signed several regional trade agreements with other trade partners, which enable Russia access to their markets on a preferential base, i.e. with lower or zero tariffs and without other obstacles to trade.

In retaliation to the EU sanctions, in March 2022 the Russian authorities announced a list of more than 200 items on which they imposed a ban on the export. They included telecommunication, agricultural, electric and technological equipment with an application until the end of this year. Besides this, Russia also issued the decision to ban a number of EU nationals, including officials of the EU and from the member states, as well as members of the European Parliament and member states' parliaments, from entering the territory of the Russian Federation (European Union External Action, 2022). The Russian government also prepares measures that include bankrupt and the nationalisation of foreign companies' property. In April Russia froze the supply of gas to Bulgaria and Poland due to the rejection to pay for gas in roubles. A freeze on the gas supply to Europe by Russia can be a very strong weapon of the Russian government against Europe in this trade war. On the whole, since May 2022 the Russian government has announced several resolutions and taken measures (The Russian Government, 2022) in response to the economic sanctions which were imposed by the West countries on Russia. They include:

- The government approves rules for transactions with foreign companies from unfriendly countries and territories (Resolution No. 295, 431-p of 6 March 2022);
- The government bans the export of foreign-made medical products from Russia (Resolution No. 302 of 6 March 2022);
- The government approves a list of goods and equipment the export of which will be suspended;
- The government lifts the restriction on crossing the Russia-Belarus border;
- The government takes another decision to regulate metal exports.

Besides restrictive measures, the Russian authorities have also signed several resolutions that fast-track the imports of some products (for example electronic devices and equipment) in order to prevent shortages of such goods on the domestic market. From the view of value added, the EU27 adds 3.2%

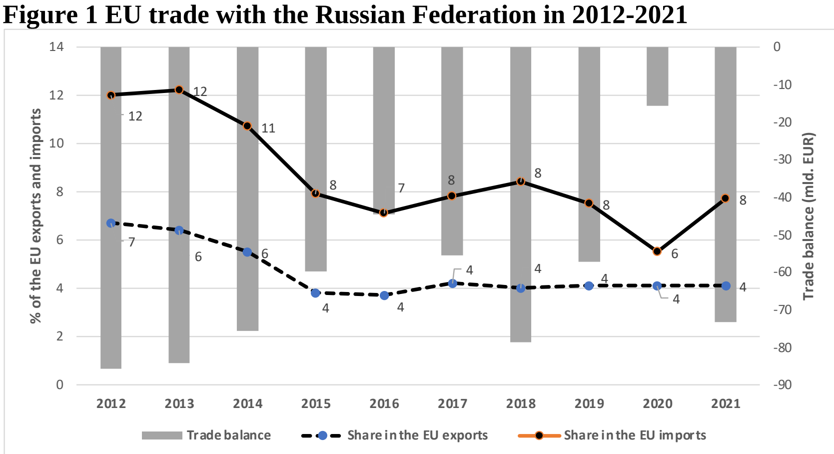
value to the Russian gross exports (China 1.2% and the USA 0.8%), while the domestic value accounted for more than 91%. The share of the EU's value added in the Russian final consumption is about 7%, China contributes by 3.3% and the USA creates 1.7% added value (OECD, 2021).

IV. Trade War: Who Is the Winner?

The main intention of this paper is to evaluate the impact of the economic sanctions that have been imposed reciprocally by the EU and Russia since May 2022 on the EU-Russia bilateral trade, and to discuss the consequences of the restrictive measures on both economies.

Figure 1 shows that during the last ten years Russia's share in the EU external trade declined by 4 percentage points (p.p.) on the import side, and by 3 percentage points on the export side. Russia recorded a decline of its position on the EU market especially after 2014, i.e. after the first wave of the EU's economic sanctions. Another significant decline was recorded in 2020, but only on the import side, while Russia's share in the EU exports remained on a stable level. This development was influenced by the structure of the Russian exports to the EU, which is predominantly created by primary goods (68% of the EU imports from Russia in 2021), namely energy, which accounted for 62% of the total EU imports from Russia (Eurostat, 2022a). Primary products were less demanded at the time of the COVID-19 pandemic in 2019-2020 due to limited production. In 2021, Russia's share in the EU imports grew again, and Russia ranked among the main EU external trade partners; it was the fifth largest partner for the EU exports of goods and the third largest partner for the EU imports of goods (Eurostat, 2022a). The significant dependence of the EU on the import of energy such as gas, oil and coal also contributed to EU's trade deficit with Russia throughout the whole period. However, differences in the amounts of imports from Russia among the individual member states are significant. While Russia's share in the total extra-EU imports of Malta, Luxembourg and Ireland was less than one percent in 2021, it was almost 40% in Finland, Estonia, Lithuania and Latvia (Eurostat, 2022a).

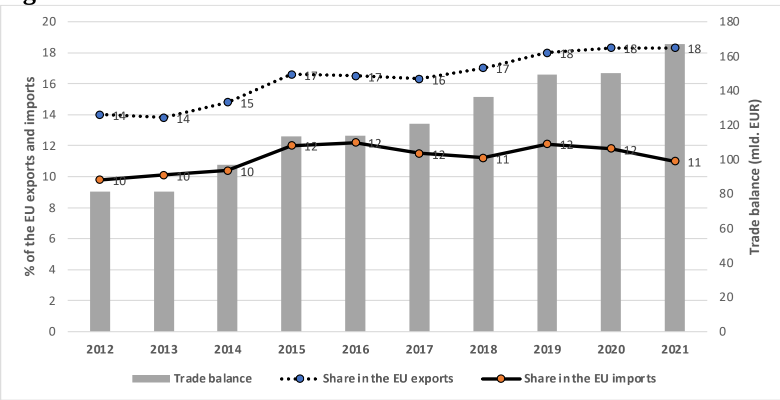
Figure 1 EU trade with the Russian Federation in 2012-2021



Source: own processing according to Eurostat (2022b)

The economic sanctions resulted in trade diversion from Russia to the USA and other countries, which also imposed restrictive measures on Russia in cooperation with the EU. However, while the USA's share in the extra-EU imports increased only by 1 p.p. in the period 2012-2021, the USA's share in the extra-EU export side increased by 4 p.p., and the EU recorded growing trade surpluses with the USA (see Figure 2).

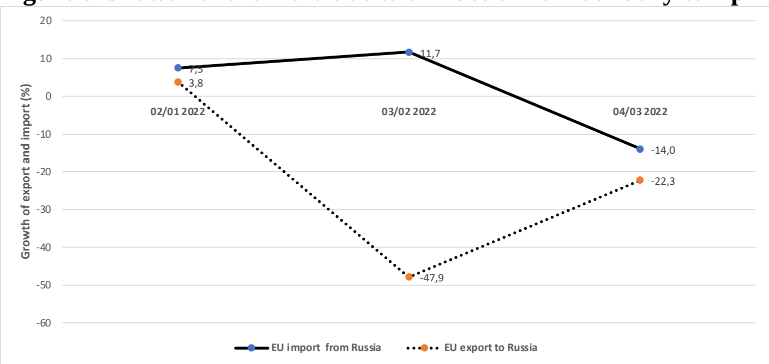
Figure 2 EU trade with the USA in 2012-2021



Source: own processing according to Eurostat (2022b)

The impact of the sanctions, which have been imposed by the EU on Russia since February 2022, on the EU bilateral trade with Russia is obvious from Figure 3 that records changes in trade on a month-on-month base. While the EU exports and imports grew by 3.8 % and 7.5 % in February 2022, in March the EU exports declined by almost 48 %, but the imports still recorded an almost 12% growth. In April the EU trade with Russia declined on both sides, i.e. export as well as import.

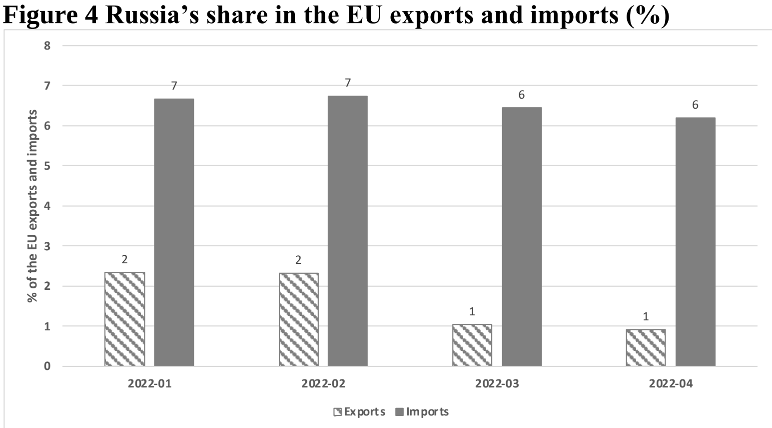
Figure 3 Growth of the EU trade with Russia from January to April 2022



Source: own processing according to Eurostat (2022b)

Besides the decline of trade, Russia's share in the EU exports and imports was also recorded. Figure 4 shows that although export and import declined between January and April evenly by one percentage point, Russia's share in the EU imports greatly exceeded its share in the EU exports.

Figure 4 Russia's share in the EU exports and imports (%)

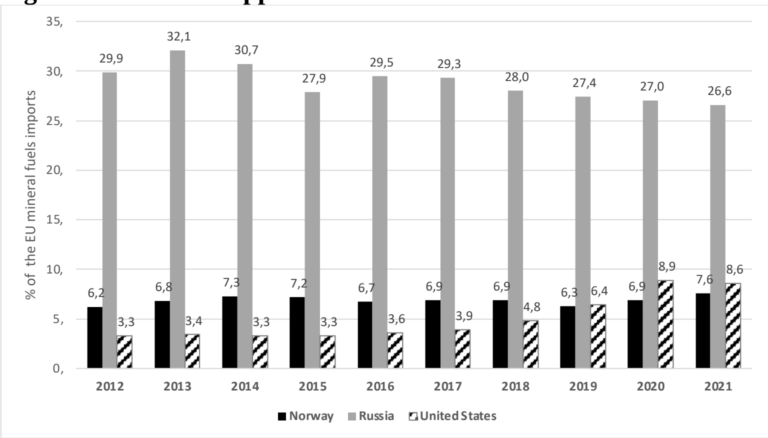


Source: own processing according to Eurostat (2022b)

Besides the economic sanctions that the EU imposed on Russia in light of Russia's invasion of Ukraine, as early as March 2022 the European Commission proposed a plan to make Europe independent of Russian fossil fuels well before 2030, starting with gas (European Commission, 2022a). With respect to the fact that the EU currently imports 90% of its gas consumption, and Russia makes up around 45% of it, it is really a serious decision. In addition, Russia also accounts for around 25% of oil imports and 45% of coal imports in the EU (European Commission, 2022a). In order to ensure more affordable, secure and sustainable energy, in its REPowerEU plan the European Commission also proposed a set of measures with a focus on the mitigation of the impact of high energy prices on vulnerable consumers, providing short-term support to companies affected by high energy prices, insuring gas storage across the EU, and diversifying gas supplies via higher Liquefied Natural Gas (LNG) and pipeline imports from non-Russian suppliers. The European Commission also states that trade diversion from Russia also contributes to the acceleration of green transmission and overlapping "Fit for 55" objects (European Commission, 2022a). During the European Council summit in May 2022, the EU leaders agreed on actions to further secure energy supply. However, supportive measures will increase the government gross debt, which has already reached on average more than 88% of the EU's GDP, and in Greece, Italy and in many other countries it is much higher, i.e. reaching up to 193% of GDP (Eurostat, 2022c). In addition, the support will be done selectively in the individual member states, with different impact on industrial branches and the living standard of people.

In terms of the import substitution policy, the EU continues to work with neighbours and partners in the Western Balkans. A new level of cooperation between the EU and the Gulf Cooperation Council is also discussed, and the EU Egypt Israel Memorandum of Understanding about, among other things, the export of gas to the EU was written in July 2022 (European Commission, 2022b). Currently, both countries share in the EU mineral fuels imports by less than one percent. Thus, it is more a political gesture than a responsible economic way how to insure a safe energy supply to Europe. The U.S. president Biden has also promised to increase the LNG supply to Europe to 50 bcm by 2030, equalling approximately one-third of the EU's gas imports from Russia in 2021 (The Guardian.com., 2022). However, it is not humanitarian aid, but clear business, which was already agreed between the European Commission's President Juncker and U.S. President Trump in their Joint Statement of July 2018 (European Commission, 2019). It is obvious that the diversion from the Russian supplies will be a big opportunity for other countries, such as the USA, to increase its LNG export to Europe and lower its trade deficit with the EU. In addition, other countries, such as India, China, etc., are increasing their imports of Russian gas and oil in order to export them to the EU (BBC News, 2022; iDNES.cz, 2022). Thus, although the EU is trying to substitute Russian fuels by new energy suppliers or sellers of fuels which will probably have origin in Russia, another issue is the price which Europe will pay for them. Figure 5 shows the three main destinations, i.e. Russia, the USA and Norway, which shared in the EU27 mineral fuels imports the most in the period 2012-2021. While Norway's share was relatively steady during the monitored period, the supply of fuels from the USA increased by more than 5 p.p., and dropped slightly from Russia.

Figure 5 The main suppliers of mineral fuels in the EU in 2012-2021 (%)



Source: own processing according to Eurostat (2022b)

The drop in bilateral trade between the EU and Russia, due to the economic sanctions, is clear. Despite the economic sanctions Russia earned 98bn USD from oil and gas exports during the first 100 days of the war in Ukraine (from 24 February to 3 June), namely due to the growing prices of fuels in the world market. The EU made up 61% of these imports, worth approximately 59bn USD (BBC News, 2022). Due to the rise in the prices of oil and gas, strong sales, a fall in Russian imports and credit controls which prevented Russians from buying foreign currency, the Russian rouble has appreciated to the USD by 14% since January 2022 and become the best performing currency in the world (Economics, 2022). In the first quarter of 2022 the Russian economy expanded by 3.5 % year-on-year, and the Russian government plans to spend 2.5 trillion roubles (32.3 billion USD) on supporting its economy (Reuters, 2022), which faces economic sanctions and a more than 17% inflation (The Central Bank of Russia, 2022). Instead of the EU that records a general government debt that accounted for 88% of GDP EU27 (Eurostat, 2022c), Russia records a 21% surplus (WTO, 2022).

In the EU27, the GDP growth was 5.2% in the first quarter of 2022 (Eurostat, 2022e) and the inflation reached 8.8% in May 2022, namely due to the permanently growing energy prices (Eurostat, 2022d). High energy prices, shortages of metals and a limited supply of oil and gas will have a probable negative influence on the EU industry and its competitiveness. As history confirms, the economic sanctions will have implications for the economic and social development of all, although on a different scale. While the political decision to impose economic sanctions on Russia is the result of the common stance of the EU27, solving economic consequences of reciprocally imposed sanctions remains on the level of the individual member states, although in the EU coordinate framework. As Moeeni (2022) states, economic sanctions are successful in achieving political goals, but they can hurt the civilian population. These negative effects could be even more detrimental and long-lasting for the future generation.

V. Conclusion

The long-term as well as short-term development of the EU-Russian exports as well as imports showed a decline tendency on both sides of trade. However, the importance of Russia, as the main supplier of fuels to the EU, contributed to the fact that Russia remained the fifth largest extra-EU trade partner until 2021, and the EU was the main export and import destination for Russia. Although the EU27 as a whole is energy-dependent on Russian imports of fuels and raw materials, the EU imposed six packages of restrictive measures on Russia and expanded the import substitution policy due to the war in Ukraine. It evoked retaliations on the side of the Russian authorities. The result of this protectionism is the escalation of tensions which resulted in a trade war between the EU and Russia with many economic consequences. Who will be the winner in this war? Historical experience shows that the winner was usually the third side, i.e. the winners will be those countries that will fill the gap on the EU's as well as the Russian market. While the EU27 cooperates namely with other West countries from the G7 Group and negotiates new strategic partnerships with potential fuel suppliers in Asia and Africa, Russia has strengthened its economic and trade relations namely with China, which is currently the largest country in the world from the GDP and population point of view. However, a growing demand for the Russian fuels is also heard from India, South Korea, Japan and many other countries around the world. Although new strategic partnerships are developed by both sides, i.e. the EU as well as Russia, empirical studies confirm that the impacts of the sanctions will have global consequences due to the internationalisation of production and trade. Thus, every politician should be aware of this important fact before they make a decision to impose sanctions. The current situation will probably bring changes in the trade order and create new economic superpowers with new technologies, human and capital resources and well-equipped land with raw materials. This issue opens other interesting topics for carrying out serious trade analyses based on econometric models and statistical data.

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