The Impact of Sanctions on Russia

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Abstract

This article provides a concise overview of the sanctions that the Western countries imposed on Russia as a result of its aggression in Ukraine. The sanctions are likely more serious than President Vladimir Putin anticipated, but have yet to induce Russia to engage in more cooperative behavior.

An Unexpected Invasion

Vladimir Putin's decision to annex the Crimea in March 2014 caught the international community by surprise. Recognition of national sovereignty and the inviolability of borders are central to the international state system, and since 1991 the Russian Federation (like the Soviet Union before) had been an ardent defender of these principles.

Russia was incensed by the Western recognition of the independence of Kosovo in February 2008, and responded by granting recognition to South Ossetia and Abkhazia in August 2008. Still, Crimea was assumed to be immune to irredentist claims from Russia, not least because Russia had signed the 1994 Budapest Memorandum guaranteeing the territorial integrity of Ukraine, in return for the latter giving up its nuclear weapons.

Putin's action demanded a response. Since military action by the West was off the table, given Russia's nuclear arsenal, economic sanctions were the tool of choice. Sanctions have become an increasingly popular instrument over the past two decades: they apply pressure on intransigent governments without risking the destruction that military action entails.

Their record has been mixed. They are most effective when they are multi-lateral, and they succeed about one third of the time – though skeptics question whether the desired changes in government behavior can be attributed to sanctions alone.[1] Sanctions helped bring about the end of apartheid in South Africa, but have failed to halt the nuclear ambitions of North Korea or Iran. They are a blunt instrument, harming the economies of the countries applying the sanctions along with the target nation. Sometimes they trigger an aggressive response by the offending country, deepening the crisis. Typically the costs of sanctions are borne by the common people and not the leaders making the decisions. Critics argue that sanctions are a demonstrative act that allows leaders to make a moral statement, without actually influencing developments on the ground.

Hence there arose the idea of "smart" sanctions that impose travel bans and asset freezes on individual members of the elite.[2] In 2012 the US Congress passed the Magnitsky Act, under which in April 2013 18 named individuals were sanctioned for participation in the 2009 death of corporate lawyer Sergei Magnitsky. This was a precedent for the sanctions that were introduced on Russia in the wake of the annexation of Crimea.[3] Russia retaliated against the Magnitsky Act with the "Dima Yakovlev" law

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[1] Gary Clyde Hufbauer et al (eds.) *Economic Sanctions Reconsidered* (3rd edition) (Washington DC: Peterson institute, 2009), 127.
[2] Uri Friedman, "Smart sanctions: a short history," *Foreign Policy*, April 23, 2012. The first individually targeted sanctions were against Haiti in 1993.
[3] Emma Gilligan, "Sanctioning Russia: Magnitsky, Human Rights and the Ukrainian Crisis" (forthcoming).

banning U.S. adoptions, and a list of 18 Americans sanctioned for involvement in the Guantanamo Bay detention center and the arrest of Russian arms dealer Viktor Bout.

The West Responds to Russian Aggression

Less than a week after President Viktor Yanukovich fled Ukraine on February 22, unidentified pro-Russian gunmen were seizing public buildings in Crimea. Separatist rallies took place in many cities of eastern Ukraine; Russian troops were deployed to the Ukrainian border; and on March 1 the State Duma passed a resolution authorizing the use of Russian troops in Ukraine.

On March 16 Crimeans voted in a hastily organized referendum to join the Russian Federation. The next day the US and EU imposed asset freezes and travel bans on 21 individuals deemed to be directly involved in the occupation of Crimea. Nevertheless on March 18 Putin signed into law a bill adding Crimea to Russia, and delivered a remarkable speech in which he embraced the rhetoric of Russian ethno-nationalism, including ominous language condemning "national traitors."[4] Two days later President Barack Obama added several more names to the sanctions list, including what one administration official described as "Putin's cronies, his money people," such as Gennady Timchenko, Yuri Kovalchuk, and Arkady and Boris Rotenberg.[5] The theory was, in President Obama's words, that "we can calibrate our response based on whether Russia chooses to escalate or to de-escalate the situation."[6] Russia responded by banning nine U.S. officials from visiting Russia. Senator John McCain joked that "I guess this means my spring break in Siberia is off." On March 24, meeting on the sidelines of a nuclear security summit in The Hague, leaders of the G7 group of advanced economies announced that it was suspending Russia's membership (Russia had joined in 1998, making it the G8) and cancelling the summit that was scheduled to meet in Sochi in June 2014.

Fighting broke out in eastern Ukraine in April, culminating in a May 11 referendum in which Donetsk and Lugansk allegedly voted for independence. Unlike in Crimea, Russia did not act on the results of these referenda. Fighting intensified as the summer progressed, though Russia seemed to be signaling that it was interested in a compromise solution.

On April 28 the U.S. added seven more individuals and 17 related companies to the sanctions list.[7] But with the EU economy stagnating, the powerful Ostauschuss group of German industrialists doing business with Russia urged Chancellor Angela Merkel not to bow to U.S. pressure to introduce broader sanctions.[8] On July 16 the U.S. moved beyond "smart" sanctions on individuals to introduce "sectoral" sanctions on strategic corporations.[9] Two energy firms (Rosneft and Novatek) and two banks (Gazprombank and Vneshekonombank) were barred from all but short-term borrowing (more than 30 days) on U.S. markets, and eight Russian arms firms were embargoed.

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[4] "Address by President of the Russian Federation," March 18, 2014. http://eng.kremlin.ru/transcripts/6889

[5] Mark Landler, "Obama steps up Russia sanctions," *New York Times*, March 20, 2014. Kovalchuk's Bank Rossiya was also embargoed. The day before, March 17, Timchenko had sold his 43% in oil trader Gunvor to his Swedish partner Torbjorn Tornqvist.

[6] "Obama's statement on new sanctions against Russia," *New York Times*, March 17, 2014.

[7] US Treasury, "Announcement of additional Russian sanctions," April 28, 2014. http://www.treasury.gov/press-center/press-releases/Pages/jl2369.aspx

[8] Matthew Karnitschnig, "German businesses urge halt on sanctions against Russia," *Wall Street Journal*, May 1, 2014.

[9] US Treasury, "Announcement of Treasury sanctions on entities within the financial Services and energy sectors of Russia," July 18, 2014. http://www.treasury.gov/press-center/press-releases/Pages/jl2572.aspx

Then on July 17 separatists shot down Malaysian Airlines Flight 17 en route from Amsterdam to Kuala Lumpur, killing all 298 on board. This atrocity, and Russia's seeming unwillingness to help bring those responsible to justice, caused a groundswell of support for tougher action, particularly in the Netherlands and Germany. On July 25, the EU expanded its sanctions to an additional 15 top Russian government officials and 18 entities (including organizations active in the separatist regions, and corporations illegally seized by Russian authorities), followed by an additional eight individuals and three entities on July 30.

Putin responded by doubling down: on August 6 he announced a one-year ban on imports of fruits and vegetables, dairy products and meat from countries that had imposed sanctions on Russia.[10] Russia is the EU's second biggest food market after the U.S., and EU imports accounted for 25-30 percent of the food consumed in Russia. In 2013 Russia imported $16 billion of food from the EU and $1.6 billion from the U.S.[11]

Meanwhile, many Western companies with long-term commitments in Russia assumed the sanctions would soon blow over. Exxon continued its work with Rosneft in the exploration of the Arctic shelf, under a 2011 partnership agreement. In defiance of pressure from the U.S. government, they started drilling with their West Alpha rig on August 9.[12]

During August intensified attacks by Ukrainian forces were closing in on the rebel-held cities of Donetsk and Lugansk, but increased action by Russian military units (whose presence Moscow either denied or described as "volunteers") forced the Ukrainian government to sign a cease-fire on September 5.

On September 12, 2014, the U.S. and EU imposed additional penalties. The U.S. Treasury barred the banks Sberbank, Bank Moskvy, Gapzrombank, Rosselkhozbank and VTB, and defense industry conglomerate Rostec, from raising funds of more than 30 days maturity; for Transneft, Gazpromneft, Novatek and Rosneft the limit was 90 days.[13] Russian companies will have to refinance about $130 billion of debt by the end of 2015, and the sanctions will make this a more costly proposition. The EU sanctions also targeted bank credits and weapons manufacturers, and issued an updated list of 24 sanctioned individuals.[14] The more radical option of cutting Russia off from the SWIFT inter-bank clearing system (something that was done to Iran in 2012), was not adopted.

Other countries joined the sanctions regime at various points over the spring and summer – including Australia, Canada, Japan, Norway, Switzerland and Ukraine. However, Turkey, Greece and Cyprus refused to embargo Russia – and as a result they experienced a surge in exports and Russian tourists.

The sanctions tit-for-tat was a strange kind of limited economic warfare. Each side imposed real costs on each other – and on themselves. But they both stayed away from the elephant in the room – the flow of oil and gas from Russia to Europe. With Russia providing 39 percent of Europe's natural gas in 2013, and with oil and gas covering 50 percent of the Russian budget, it would have been severely disruptive to interrupt that trade. In June Russia did suspend gas deliveries to Ukraine pending resolution of $3 billion in unpaid bills. This was not an urgent problem since it was summer and demand was low, and Ukraine

[10] http://eng.kremlin.ru/news/22780

[11] http://rt.com/business/178708-russia-europe-food-ban/

[12] Alan Katz, "Exxon riles US, EU by using sanctions loophole," Bloomberg, September 12, 2014. http://www.bloomberg.com/news/2014-09-12/exxon-said-to-rile-u-s-eu-in-using-sanctions-loophole.html

[13] U.S. Treasury, "Sectoral sanctions identification list," September 12, 2014. http://www.treasury.gov/ofac/downloads/ssi/ssi.pdf Exxon was later given a deadline of October 10 for finishing sealing the well at the West Alpha rig in the Kara Sea.

[14] Official Journal of the European Union, L 271, September 12, 2014. http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=OJ:L:2014:271:TOC

had ample gas reserves in storage. (Also Poland, Hungary and Slovakia were willing to pump gas to Ukraine.) But winter was coming. After protracted negotiations over the next three months, a deal was struck in Brussels on October 29, under which the EU and IMF will lend Ukraine the money to cover its debt to Gazprom and pre-pay $1.5 billion for supplies during the coming winter.[15]

The Economic Impact of the Sanctions

Perhaps more damaging than the sanctions themselves was the general atmosphere of uncertainty created by Putin's seemingly reckless actions in Ukraine, and his reaction to Western sanctions. The market response to the annexation of Crimea was swift and more immediately damaging than the official sanctions. Russian share prices plummeted, the ruble fell, interest rates rose and capital flight accelerated, reaching $120 billion by October (more than double the typical annual outflow).

Germany is Russia's largest trading partner after China. German exports to Russia in August 2014 were 26 percent down on August 2013 (a yearly decline of over $6 billion).[16] Although Russia only accounts for 3.3 percent of total German exports, the impact was felt in the engineering and auto industries, where Russia is the 4th and 9th largest customer. Russia only accounts for about 1 percent of U.S. exports. Vulnerable companies include Boeing, GE (which sold $1.7 billion of turbines and other equipment in Russia in 2012),[17] and Morgan Stanley, which had to cancel the planned sale of its oil trading division to Rosneft.

The impact of sanctions on Russia's banking sector was buffered in the short term by the state's large cash reserves. Even after spending $50 billion to slow the pace of ruble depreciation, which slid 25 percent between January and October, Russia still had $445 billion in reserves.[18] There were more signs of immediate impact in the oil sector. Western companies started winding down their new exploration projects in Russia, which remains crucially dependent on certain foreign technologies for deep offshore and fracking operations. In June Rosneft bought the Swiss-based oil services company Weatherford for $400 million, and in July signed a $4.2 billion contract for six rigs with Norway's North Atlantic Drilling. In September Putin announced plans to create a national oil services company. Nevertheless, the consultancy IHS CERA estimates that the sanctions, if maintained, could cause a 25 percent drop in Russian oil output by 2025.[19] Similarly, Lukoil's Vagit Alekperov estimated that 20 percent of output was at risk.[20]

The airline sector has also been affected. Aeroflot's low-cost subsidiary Dobrolyot was hit by EU sanctions because it flies to Crimea; it has suspended operations after losing leases for its Boeing and Airbus aircraft. The fear that Russia could close its airspace to European and U.S. carriers flying to Asia dented airline stock prices.

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[15] Charles Oliver, "Russia and Ukraine reach gas deal," *Financial Times*, October 30, 2014. Ukraine agreed to a price of $378 through December 2014 and $365 from January to March 2015.
[16] Jeevan Vasagar, "German exports to Russia tumble," *Financial Times*, October 30, 2014.
[17] Ted Mann, "GE's Russia plans stall amid Ukraine turmoil," *Wall Street Journal*, March 28, 2014.
[18] Ol'ga Kuzminova, "Valyutnye rezervy TsB" (The Central Bank's currency reserves), *Vedomosti*, October 24, 2014. The ruble fell from 33/$ to 41/$.
[19] Jack Farchy, "Russian oil: between a rock and a hard place," *Financial Times*, October 29, 2014.
[20] Alexander Panin, "Western sanctions could damage one fifth of Russia's oil production," *Moscow Times*, September 21, 2014.

Putin responded by circling the wagons: the state would bail out companies hard-hit by the sanctions. The arrest of billionaire Vladimir Yevtushenkov in September and the reversal of his purchase of the Bashneft oil company (long coveted by Igor Sechin's Rosneft) was another reminder of the vulnerability of Russian businesses to the whims of the Kremlin. The most politically risky step was the State Duma's passage in October of a bill promising compensation to Russian citizens whose assets were frozen by foreign governments, possibly through seizing foreign assets in Russia. It was jokingly called the "Rotenberg law" after long-time Putin associate Arkady Rotenberg, who had $40 million of assets in Italy frozen.[21]

The sanctions pushed the Putin administration decisively down the path of an autarchic development strategy. The depreciation of the ruble has helped to cut imports and made Russian goods more competitive.[22] As Aleksei Kudrin noted "There are forces in the country who have long wanted isolation, maybe a certain self-sufficiency. Today this has all fallen on fertile ground."[23] Conservative economists such as Sergei Glaziev have long been pushing for state-led reindustrialization, with protection against foreign imports and spending oil revenues on infrastructure and new technology.[24] Their hour has now come.

For example, Russia is making some serious steps to try to build institutions independent of global financial markets. In March when Visa and MasterCard suspended processing payments at Russia's SMP and Rossiya banks, it was decided to move ahead with creating a National Card Payment System under Russian control. Russia is looking to increase the proportion of tis trade with China denominated in rubles and yuan: currently about 8 percent of Russian imports are settled in yuan.[25]

However, it is not clear whether the Russian state has the institutional capacity, or the deep pockets, to steer the nation's economic development while disengaging from ties with Europe and the U.S. The sanctions came at a time when the Russian economy was already facing severe structural weaknesses.[26] Even before the Ukraine crisis, economists were predicting very modest growth this year – less than 2 percent. Russia urgently needs to increase investment to overcome decades of under-spending on infrastructure and new technology. For example, they need a 50 percent, $6 billion increase in exploratory drilling to maintain current oil output levels.[27]

The slump in the global oil price (which fell 25 percent in the first 9 months of 2014) puts severe pressure on the Russian federal budget. The latter had planned to break-even in 2014 and 2015 with oil at $97 and $100 a barrel respectively: as of October it was trading at $88.[28] Every $1 fall in the oil price cuts federal tax revenue by about $1.4 billion. Maksim Oreshkin, a department head at the finance ministry, estimated

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21 Andrew Kramer, "Russia seeks sanctions tit for tat," *New York Times*, October 8, 2014.
22 Mikhail Leont'ev, "Istoriya s sanktsiiam dolgo zhit ne budet" (The sanctions story will not last long), *Kommersant.FM*, July 25, 2014. http://www.kommersant.ru/doc/2531867
23 Aleskei Kudrin, Itar-tass, July 22, 2014. http://itar-tass.com/opinions/interviews/2223
24 Sergei Glaz'ev, "Nuzhno opirat'sya na sobstvennye sily" (We must rely on our own strength) *Profil*, May 12, 2014. http://www.glazev.ru/econom_polit/359/
25 http://www.bloomberg.com/news/2014-09-23/moscow-s-mr-yuan-builds-china-link-as-putin-tilts-east.html
26 Vladimir Mau, "V ozhidanii novoi modeli rosta," (Waiting for a new growth model) *Voprosy ekonomiki*, 2, February 2014, 3-42.
27 Petr Tret'yakov, "Rossiiskim neftyanikam nado v 1.5 raza uvelichit' burenie" (Russian oil must increase drilling by 50%), *Vedomosti*, October 23, 2014.
28 Carol Matlack, "Will cheap oil choke the Russian economy?," Bloomberg, October 13, 2014. http://www.businessweek.com/articles/2014-10-13/oil-prices-are-hurting-russias-economy

that the fall in the price of oil will cost Russia 2 percent of GDP over the next year, and the sanctions another 2 percent.[29] Most forecasters are predicting zero growth for the Russian economy in 2015.

On August 5 the government announced that $8 billion would be taken from the pension fund to cover budget spending (for the second year running). Deputy economic development minister Sergei Belyakov was fired after criticizing the decision on Facebook.

The Political Impact of the Sanctions

As Clifford Gaddy and Barry Ickes note,[30] even though the sanctions may inflict pain on the Russian economy, they are unlikely to bring about a change in Putin's political course. Russia's economic position is not so perilous, nor Putin's grip on power so fragile, for us to expect the Russian president to buckle. His strategy of shifting from "tightening the screws" on the opposition to "tightening the belts" of the Russian people seems to have struck a popular chord. After the Western reprisals, Putin's approval rating soared to new heights, reaching 88 percent in October – up from 69 percent in February 2014, before the crisis began.[31]

It is hard to image any circumstances under which Putin would revoke the annexation of Crimea. In that sense, the initial Western sanctions were primarily aimed at deterring future aggression. Unfortunately they also failed in that regard, since Russia moved ahead with covert and then increasingly overt support for separatists in Donbass and Lugansk. It is possible that the sanctions did help deter Putin from annexing Donestk and Lugansk, although other factors weighed in his decision – notably, fear of getting bogged down in a protracted guerrilla war, which would have been deeply unpopular with the Russian public.

Some Russians believe that the real purpose of the sanctions is to bring about regime change in Russia – arguing that the U.S. has given up on trying to find a modus vivendi with Putin, and is bent on orchestrating a color revolution in Moscow. While that is far-fetched, it is true that many U.S. policy makers are looking forward to dealing with a Russia without Putin. While some analysts believe that the contradictions of the Putin regime will bring about its downfall in 2-5 years,[32] realistically, Putin seems politically impregnable for the foreseeable future.

The Western sanctions may actually have prolonged Putin's longevity, by inadvertently playing into the anti-Western, conservative nationalist narrative which the Russian president embraced in the wake of the anti-Putin protests in the winter of 2011-12.[33] Putin can point to the sanctions as evidence of the Western desire to punish and weaken Russia. He told the Valdai Club in October, referring to "Our American friends," that "They are trying to hurt us through these sanctions, block our development and push us into political, economic and cultural isolation, force us into backwardness in other words. But let me stress that Russia is not going to get all worked up, get offended or come begging at anyone's door." [34]

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[29] Georgii Peremitin, "V Minfine otsenili usherb Rossii ot sanktsii" (The Finance Ministry estimates the cost of sanctions for Russia), RBK, September 24, 2014. http://top.rbc.ru/politics/25/09/2014/951207.shtml

[30] Cliff Gaddy and Barry Ickes, "Can sanctions stop Putin?" Brookings Institution, June 2, 2014.

[31] http://www.levada.ru/29-10-2014/oktyabrskie-reitingi-odobreniya-i-doveriya

[32] Peter Rutland, "How much longer can Putin's system last?," *Moscow Times*, October 27, 2014.

[33] Ilya Yablokov, "Pussy Riot as agent provocateur: conspiracy theories and the media construction of nation in Putin's Russia," *Nationalities Papers*, 42: 4, September 2014, 622-636.

[34] Vladimir Putin, speech at meeting of Valdai International Discussion Club, October 24, 2014. http://eng.kremlin.ru/transcripts/23137

The sanctions were also taken as proof of the wisdom of Putin's policy of "nationalizing" the elite by barring senior officials from holding foreign bank accounts. Russian politicians took pride in being included on the sanctions list. For example, Putin's Chief of Staff Sergei Ivanov told the head of Gazprombank Andrei Akimov that "until your name is on the sanctions list you cannot consider yourself part of our country's elite."[35] The sanctions make it less likely that any powerful figure would challenge Putin, since they remove the option of emigrating to Europe, and makes them more dependent on state support for their businesses to survive. Aleksandr Morozov writes that "personalized sanctions create a hard form of loyalty: people have no alternative but to support any future actions of the leader."[36]

The main beneficiary of the sanctions regime is China. "The downturn in relations with West may mean Russia's 'turn to the east' is no longer an opportunity but a necessity."[37] Although China abstained in the UN vote condemning the Crimean annexation, rather than support Russia, they are happy to extend loans and step up international cooperation. After more than a decade of negotiations, on May 21 China signed a $400 billion, 30 year deal to buy natural gas from Russia. The price is not yet known, but was widely assumed to be unfavorable to Russia. Russia's eastern "pivot" has added fuel to Russian strategists who warn against increasing dependency on China.[38] The Russian public seems accepting of the turn to Asia: in September 2014, 44 percent rated relations with China as good or friendly, and 35 percent as normal.[39] In the same survey, however, 66 percent said they thought it was time for Russia to repair its relations with the West.

An Interim Conclusion

If Putin was assuming that the sanctions were a passing fad, and that the Western powers did not have the stomach to stand up to his aggression, he was mistaken. But if the Western leaders assumed that Putin would respond to carefully calibrated incentives for cooperation, they were also mistaken. It looks increasingly likely that Putin prefers the status quo, leaving unresolved the legal standing and practical governance of eastern Ukraine. If that is the case, then the current sanctions may be in place for some time.

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[35] Evgeniya Milova, "S pozdravetel'noi notoi" (With a welcoming note) *Kommersant*, September 15, 2014. http://kommersant.ru/doc/2567304

[36] Aleksandr Morozov, "Novoe obshchestvo Putina kak evropeiskii proekt" (Putin's new society as a European project), russ.ru, November 2, 2014. http://russ.ru/Mirovaya-povestka/Novoe-obschestvo-Putina-kak-evropejskij-proekt

[37] Mikhail Losev. "Nefritovym kursom" (Jade exchange), RBC Daily, September 21, 2014. http://www.rbcdaily.ru/magazine/trends/562949992295539

[38] Andrei Lipskii interview with Vyacheslav Inozemtsev, "Rossiya ischet, pod kogo zalezhat" (Russia is looking for someone to crawl behind), *Novaya gazeta*, October 18, 2014.

[39] Levada Center, "Russia and the world," October 10, 2014. http://www.levada.ru/eng/russia-and-world