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Do sanctions against Russia work?

by Iana Dreyer and Nicu Popescu

Sanctions have become a key policy tool in the EU's response to Russian actions in Ukraine. This has generated a debate inside Europe, first and foremost, on whether such measures work, and on whether or not they should continue, be upgraded or scrapped altogether. The debate revolves around two important questions: do sanctions have an economic impact on Moscow – in other words, do they hurt? And are they effective enough to change Russia's behaviour in Ukraine?

The restrictive measures and their scope

The current sanctions placed on Russia and on certain local actors from Crimea and Ukraine's Donbas region were initiated by the EU and the US, and are supported by a host of countries including Albania, Australia, Canada, Iceland, Japan, Liechtenstein, Moldova, Montenegro, Norway, Switzerland and Ukraine.

As Francesco Giumelli explains in EUISS Chaillot Paper 129/2013, international sanctions may pursue three sets of goals: *signal* to foreign target countries or domestic audiences dissatisfaction with certain policies, *constrain* the target countries or their leaders from undertaking future actions, or *coerce* a government into changing or reversing existing policies.

The EU has been very gradual in its roll-out of sanctions, in an attempt to leave the door open for negotiations. The first, small wave of sanctions – introduced between March and July 2014, i.e. between the annexation of Crimea and the shooting down of the Malaysian Airlines flight MH17 – were focused on signalling to, rather than hurting, Russia. Following the downing of the civilian aircraft, the alleged direct Russian military presence in the Donbas in August-September, and the non-respect of the 6 September Minsk ceasefire agreement, it became clear that 'signals' were not enough, and more robust sanctions were introduced.

The restrictions in place today include:

- asset freezes and visa bans on 132 persons and 28 companies or other entities in Russia/Ukraine deemed responsible for the violation of Kiev's territorial integrity;
- the suspension of preferential economic development loans to Russia by the European Bank for Reconstruction and Development (EBRD);

- a ban on trading bonds and equity and related brokering services for products whose maturity period exceeds 30 days with some of Russia's biggest state-controlled banks (including Sberbank and Gazprombank), three Russian energy companies (including Rosneft, but not Gazprom in the case of the EU), and three Russian defence companies;

- a ban on loans to five major Russian state-owned banks;

- a two-way arms embargo;

- a ban on exports of so-called dual-use items, i.e. civilian industrial goods that can be used as (or to produce) weaponry; and

- a ban on exporting certain energy equipment and providing specific energy-related services to Russia's new, innovative and technology-intensive energy projects (e.g. Arctic and deep-water exploration, shale oil).

It is the financial set of sanctions which has hurt Russia the most in the short term. Yet these measures coincide with two other major negative shocks that have befallen the Russian economy this year: a steep drop in oil prices and a sharp decline of the country's currency, the rouble. These factors are having a cumulative effect, and it is therefore hard to distinguish the specific and distinctive impact of the sanctions as such.

Weakness in numbers

Global developments have hit the already anaemic Russian economy hard. The global price of oil fell from $115 per barrel in June 2014 to approximately $65 in December, in the wake of slower growth rates in emerging markets and the (positive) supply shock generated by the shale revolution in the US. Given that oil accounts for half of Russia's federal revenue and two-thirds of its total exports, this has a serious impact on Moscow's coffers. This loss cannot be offset by selling other energy resources such as gas: 80% of Russia's hydrocarbons revenue comes from oil.

The annexation of Crimea and the consequent imposing of sanctions by the West also sparked a fresh wave of capital outflows. The Central Bank of Russia (CBR) estimates that these could reach $130 billion in 2014, compared to $61 billion last year.

Lower oil prices and capital flight have led to a sharp depreciation of the rouble, which has lost 40% of its value since January 2014. The country's stock market, or Russian Trading System (RTS) index, also dropped by 40% since mid-July. Moscow's corporate and banking sectors are heavily reliant on financing from international capital markets, and corporate debt tends to be denominated in US dollars.

Currency depreciation comes at a high cost for Russian corporations, which earn in roubles but need to repay debt in dollars and other foreign currencies. In December 2014 alone, $34 billion in bank and corporate debts and interest repayments are due; in 2015, some $106 billion needs to be paid back. Following the sanctions and the wider geopolitical uncertainties, international debt refinancing is nearly impossible for all Russian borrowers (not just those on the sanctions list), who, in turn, are seeking help from the government.

The financial sanctions reduce the availability of capital in Russia, raising interest rates. As a result of capital shortage, Russia's three-month interbank lending rate soared from 6.04% in March 2014 to 10.65% in early December, bringing many investment projects to a halt and throwing Russian companies into disarray.

It is in this context that the South Stream pipeline project was scrapped and several joint oil development ventures with companies such as Exxon, Statoil, Shell and ENI put on hold.

The Russian Ministry of Economic Development has recently reduced its growth forecast for 2014 to 0.5%, and is expecting the economy to slip into recession in 2015 (with a contraction of 0.8%). In November 2014, the Russian Ministry of Finance attempted to calculate the overall effects of the drop in oil prices, the rouble's depreciation, and Western sanctions on the country's economy. It estimated that $130 to $140 billion is being lost annually – $40 billion (i.e. one third) of which is because of sanctions.

While the economic situation in Moscow appears dire, it must be put into perspective. The current downturn seems less dramatic than the 2009 recession, though this one could be more long-lasting. The Russian government's financial situation remains relatively favourable. At an expected 9.5%, inflation is still lower than in the run-up to the 2008 financial crisis, where it peaked at above 13%. Russia's budget is balanced and its public debt levels are low. And the CBR's international reserves are still sizeable: back in 2008, Russia spent $200 billion between July and April to halt a depreciation of the rouble and bail out its state-owned companies. This year, the CBR's international reserves have shrunk at a much slower pace than during the last crisis, from $486 billion last March to $418 billion in late November.

In short, Russia has enough of a buffer to weather a 2-3 year financial storm, and Moscow appears to be betting that it will blow over relatively soon.

Sanctions at work: pros and cons

This mixed picture is fuelling the debate on whether or not sanctions work. There is no clear answer to this question, at least not yet. But the lines of argument between the two main camps are now clearly defined.

The case *against* revolves around several points. One is that, despite the sanctions, Russia is still deeply involved in Ukraine and has stepped up its military engagement in the Donbas even after the restrictive measures were announced. The sanctions, in other words, did not *coerce* Russia into reversing its posture. Moreover, sanctions help Putin domestically by uniting Russians behind him (at least in the short term) and allowing the Kremlin to tighten the screws at home – on elites and ordinary citizens alike. In the event they fatally weaken the Russian president, it is arguable that any possible alternative may be worse, as nationalists are likely to come to power.

It is also argued that, by decreasing trade turnover, sanctions also decrease future Western leverage, hurt Western exporters and cost jobs in an already fragile economic environment. Finally, sanctions are pushing Russia into the arms of China, speeding up the formation of a non-Western global financial infrastructure which poses an alternative (and a challenge) to the existing Western-dominated system.

The camp *in favour* has an equally compelling set of arguments. Advocates believe that sanctions have already had an impact in the short term and will continue to do so in the medium term. First, they made Russia seriously factor in possible Western responses to its actions in Ukraine, which seems not to have been the case prior to the annexation of Crimea.

The sanctions, in other words, *constrained* Russia as they deterred Moscow from seizing even bigger chunks of territory. The separatist areas of the Donbas form only a tiny part of what is called by nationalist elements of the Russian public *Novorossia*. The coastal city of Mariupol was not seized by Russia, when it easily could have been. There has been no attempt by Russian forces to forge a corridor bridging mainland Russia to Crimea, let alone Odessa and Transnistria.

In other words, a useful effect of the sanctions is that, even if they do not help the EU much in its policy on Crimea, they do minimise the risk that Russia will seek to openly destabilise other parts of Ukraine or, say, Moldova and Georgia. At a global level, finally, sanctions also *signalled* to other actors that unilateral military ventures will come at a cost.

Equally (if not more) important is that sanctions shattered Putin's 'contract' with the Russian people: namely, improving collective prosperity in exchange for accepting authoritarianism and the siphoning off of Russia's riches by elites. The restrictive measures, combined with the other factors now hitting the country's economy, are forcing Putin to tentatively replace his model with nationalism and anti-Westernism.

However, as Russian history suggests, patriotism might not last long in the absence of tangible economic prosperity. The collapse of the Russian empire in 1917 occurred in the wake of the initial patriotic boost of the First World War. The USSR crumbled after its economy collapsed in the 1980s. And support for Yeltsin and liberal democracy in the 1990s plummented after reforms failed to yield economic dividends.

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Sprint or marathon?

Both camps have valid points. Given how many predictions *vis-à-vis* Moscow have been proved wrong in the past, however, it is difficult to come to a definitive conclusion on whether sanctions can truly influence Russian behaviour. Restrictive measures might have bolstered Putin in the short term but might also seriously constrain him in the longer term. Yet attempting to predict what will happen in a decade or even longer is unwise. Russia changed dramatically between 1980 and 1990, and again between 1990 and 2000: ten years can prompt radical and unforeseen shifts in societal preferences.

Whereas military actions can have short-term consequences, economic sanctions are designed to make an impact in the medium to long term. In this current crisis, Russia has acted like a sprinter, and Europe, a long-distance runner: the sanctions are about turning the confrontation over Ukraine from an unwinnable dash into a winnable marathon. Expecting to measure the effects of sanctions within a few months is akin to gauging a marathon runner's pace based on the first 100 metres – difficult, to say the least.

Another important factor is that sanctions can be preventive. Accordingly, non-events are their biggest success, although, of course, they cannot be proven. EU sanctions on Russia are designed to curb further Russian aggression in Ukraine or in other post-Soviet states in the future. Perhaps the non-escalation of the conflict across Ukraine or its non-extension to, say, Moldova can be considered the greatest achievement of the restrictive measures.

However, what Russia planned to do (or not), and what was the role of sanctions in preventing (or precipitating) any future events will remain a matter of speculation and guesswork for some time to come.

Drawdown or countdown?

Finally, despite the long-term impact that they are likely to have, all EU sanctions were introduced for one year only, and will start expiring – in stages – as of March 2015. Their extension is not automatic and will require unanimity inside the EU. The outcome of the intra-EU discussion on sanctions will partly depend on whether they are judged to have effectively constrained Russia in Ukraine (and possibly elsewhere) and on the extent to which they have hurt the EU itself.

US sanctions, however, are likely to stay in place beyond 2015. As long as this is the case, most major European companies with potential interests in Russia – primarily banks, but also energy groups – will not move (back) into Russia and risk being hit by US penalties. Therefore, even a suspension or an end of EU sanctions may not bring EU-Russia economic cooperation back to pre-2014 levels – no business as usual, that is, at least not for a while.

Yet the sanctions dilemma facing the EU underscores once more that, in crises, there seldom are only good or bad policy options. The choice is more often than not between various types and degrees of poor alternatives. The challenge is choosing the least bad one.

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