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Economic Sanctions on Russia and Their Effects

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In 2014 both the European Union member states and the United States introduced a wide variety of economic sanctions against Russia as a consequence of the illegal annexation of Crimea and for undermining territorial integrity of Ukraine. They were joined in these actions by e.g., Canada, Norway, and Australia. The first round of sanctions in March 2014 was relatively mild, but the sanctions enacted in July and August 2014 (i.e., after the downing of Malaysian Airlines flight MH-17 with a Russian missile) were more stringent, including restrictions on debt financing for several large Russian companies (Christie 2016). Russia countered fairly soon with its own countersanctions, which ended exports of several types to foodstuffs from the sanctioning countries to Russia.

This note reviews the recent literature on the economic effects of sanctions on Russia. The emerging consensus seems to be that sanctions have had a detrimental effect on Russia's economic performance during the past years. However, their relative significance pales in comparison with the effects of oil prices on the Russian economy. Sanctions seem to have worked mostly through reducing Russian companies' access to foreign finance (Korhonen 2019). Also, apparently the relatively recent unilateral sanctions – i.e., sanctions not coordinated with the European Union – by the United States have increased uncertainty related to many Russian companies. This can have adverse economic effects going forward.

Russia's own countersanctions have also had their economic effects. Food variety in Russia has been reduced and food prices are higher (Volchkova et al. 2018). At the same time, production of some varieties has increased. Russia has also explicitly linked the countersanctions to its general import substitution policy, and even their timing is now different from the EU sanctions, which are renewed every six months. Therefore, it is prudent to assume that even if the EU were to end its sanctions today, Russia's food import ban would stay in place for a long time (Korhonen et al. 2018).

RATIONALE FOR ECONOMIC SANCTIONS AGAINST RUSSIA

Recent economic sanctions against Russia and some other countries (Syria, Iran, Venezuela, North Korea) have sparked a renewed interest in sanctions as a tool of foreign policy. Gould-Davies (2018) provides an overview of the issues related to goals and costs of imposing sanctions on a country. In the present context it suffices to reiterate his conclusion on the goals of sanctions against Russia: "[the sanctions'] aim was not to compel Russia to reverse its policy by ending its intervention in Ukraine and returning Crimea. Rather, they were intended to achieve three goals. First, to deter Russia from escalating its military aggression. Second, to condemn violation of international law and European norms by making clear there could be no normal relationship with the violator. Third, to encourage Russia to agree a political settlement by increasing the costs of its behavior" (Gould-Davies 2018).

Also, the relatively narrow scope of sanctions against Russia allows us to conclude that the aim was never to ruin the Russian economy or engineer a significant decrease in the living standards of ordinary Russians. Therefore, their design is quite different from e.g., sanctions imposed on Iran and North Korea.

It should also be noted that this is perhaps the first time that economic sanctions have been used against such a large and well-integrated part of the global economy. At market exchange rates, Russia's GDP in 2018 was the world's 12th largest. It is the world's largest exporter of natural gas and the world's largest or second largest exporter of crude oil (depending on Saudi Arabia's output level). This means that any constraining actions against Russia would also have repercussions outside the country. Russian companies and banks have traditionally been active in global financial markets, etc.

ECONOMIC SANCTIONS AGAINST RUSSIA AND ITS COUNTERSANCTIONS

The initial round of sanctions was relatively mild. It included restrictions on travel, asset freezes, and the proscribing of business dealings with certain individuals and enterprises, including entities based in Crimea and Sevastopol (Korhonen et al. 2018). After the downing of flight MH-17, sanctions were tightened considerably in many areas. The export and import of arms was forbidden, as was the export of dual-use goods for military use. Exports of certain types of goods related to oil exploration and production were also banned.

Most significant perhaps was the curtailing of long-term financing of Russian companies that had no direct involvement with the fighting in Donetsk and Luhansk regions. Investors in the EU and the US were forbidden to provide long-term financing to Sberbank, VTB, Gazprombank, Rosselkhozbank (Russian agricultural bank), and VEB (Russia's state-owned development bank). Initially, the financing ban applied only to loans with maturities longer than 90 days or equity financing; later, the threshold was lowered to 30 days. The long-term financing ban was also extended to oil giant Rosneft, oil pipeline company Transneft, oil exploration and refiner Gazpromneft, as well as several companies operating in the military sector.

Russia reacted to the sanctions imposed by the US and EU in July 2014 by restricting imports of selected food products, including fish, fresh milk and dairy products, and fruits and vegetables (Simola 2014). As mentioned above, these countersanctions also fit very well into the overall strategy of import substitution, which had been adopted well before the annexation of Crimea, the war in eastern Ukraine, and the resulting sanctions.

ECONOMIC EFFECTS OF SANCTIONS

In recent years, Russia's economic performance has not been stellar (Figure 1). Growth decelerated already in 2012 and 2013, even though the price of oil remained high at over USD 100 per barrel. In 2014, Russia's GDP increased by 0.7 percent, and in 2015 it declined by 2.3 percent. After its recovery, Russia's GDP growth has continued to trail global economic growth, meaning that Russia's share in the global economy continues to decline. But how much of this disappointing economic performance can be attributed to sanctions? To answer this question, we need to take note of Russia's weak economic performance before the sanctions as well. The answer to this question is further complicated by the developments in the market for crude oil. The price of Urals crude oil declined almost 50 percent between June 2014 and early 2015. As hydrocarbons constitute approximately two-thirds of Russia's merchandise exports and half of tax intake at the federal level, this price drop was a massive shock to the Russian economy. Oil prices declined further during 2015 before bottoming out in early 2016.

Although there were some relatively immediate assessments of the effects of the sanctions on Russia (Citibank 2015; IMF 2015; Gurvich and Prilepskiy 2015; and World Bank 2015), in this note I shall concentrate on more recent studies. These are able to utilize more data from the post-sanctions regime. Furthermore, Russia's national accounts have been revised, which in some cases has changed annual growth figures quite a bit. For example, Rosstat's estimate of the GDP drop in 2015, which now stands at − 2.3 percent, also shifted between the first estimate and the final release by more than 1.5 percentage points, i.e., the Russian economy was much more resilient than originally thought. Such revisions naturally make interpretation of the earlier studies and direct comparison to more recent ones difficult.

Table 1 summarizes some very recent papers concerning the macroeconomic effects of sanctions on Russia. First, the IMF (2019) looks at Russia's growth slowdown between 2014 and 2018 with the help of international macroeconomic models, and concludes that sanctions reduced Russia's growth rate by 0.2 percentage points every year during that period. However, other factors, including Russia's own macroeconomic policies, were more important. Low oil prices shaved off approximately 0.7 percentage points from GDP growth per annum. As was explained above, the oil price effect clearly seems to have a much larger effect on Russia's economic fortunes.

Second, also Pestova and Mamonov (2019) find that oil prices have been more important in driving Russia's GDP growth than sanctions. Using a Bayesian vector-autoregressive model, they determine that the cumulative effect of sanctions in 2014 and 2015 decreased the Russian GDP by 1.2 percent. They argue that sanctions have worked via reduced investment by Russian companies. Third, Barsegyan (2019) finds using synthetic control method that, on average, Russia's per capita GDP is 1.5 percent lower between 2014 and 2017 than it would have been without sanctions. Sanctions work by e.g., reducing foreign direct investment.

However, it should be noted that not all papers agree on the effects of sanctions on the Russian economy. Kholodilin and Netšunajev (2019) employ a structural vector-autoregressive model and examine the effects of sanctions on Russia and the euro area. They are much more skeptical about the effects of sanctions on Russian GDP, asserting that any negative effect from sanctions likely occurred between mid-2014 and early 2016. Also, it is difficult to ascertain the statistical significance of the effect. However, sanctions have had a clear negative influence on the real effective exchange rate of the ruble.

Figure 1
Russia's GDP Growth

Source: Rosstat.
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Table 1
Summary of Recent Studies on the Impact of Sanctions on Russian GDP

Paper	Period	Effect
IMF (2019)	2014–2018	− 0.2 p.p. per annum
Pestova and Mamonov (2019)	2014–2015	− 1.2% by the end of 2015
Kholodilin and Netšunajev (2019)	2014–2016	No statistically significant effect
Barsegyan (2019)	2014–2017	Level of per capita GDP on average 1.5% lower

Source: Korhonen (2019).

many other categories as well, hinting at the importance of trade finance and its availability as well as the importance of the price of oil.

Sanctions have worked through both foreign trade and financing, even though these two avenues also interact. Trade effects can be detected for both Russia and the sanctioning countries. Crozet and Hinz (2019) look at the effect of sanctions on foreign trade between Russia and other countries. They determine that Russia lost some USD 54 billion in exports from the beginning of sanctions to the end of 2015. Western countries imposing sanctions lost approximately USD 42 billion in exports to Russia, with more than 90 percent of this loss borne by the EU countries. Interestingly, most of this reduction in trade happened in goods that neither side had banned. Trade declined perhaps because of reduced availability of finance or greater risk aversion.

Belin and Hanousek (2019) find somewhat smaller trade effects from sanctions than Crozet and Hinz (2019) when they look at the differential effect of the EU and Russian sanctions. Exports from the sanctioning countries to Russia were USD 10.5 billion smaller from mid-2014 to the end of 2016 than in the absence of sanctions, with the effect coming mostly from Russia's countersanctions.

Cheptea and Gaigné (2018) assess that less than half of the drop in the EU exports to Russia in goods that Russia sanctioned was due to sanctions themselves. The bulk of the export decline came from a weaker ruble and the decrease in Russian purchasing power. This result would again stress the importance of the oil price for the general economic performance of Russia and for the purchasing power of Russians.

Fritz et al. (2017) apply a counterfactual analysis based on an econometric model to assess sanctions' effect on the EU countries' exports to Russia. They find that EU exports to Russia between 2014 and 2016 were USD 35 billion lower (11 percent lower compared to the baseline) than they would have been without the sanctions. In this analysis, the export drop was largest in agricultural goods targeted by Russia's countersanctions. However, exports declined in

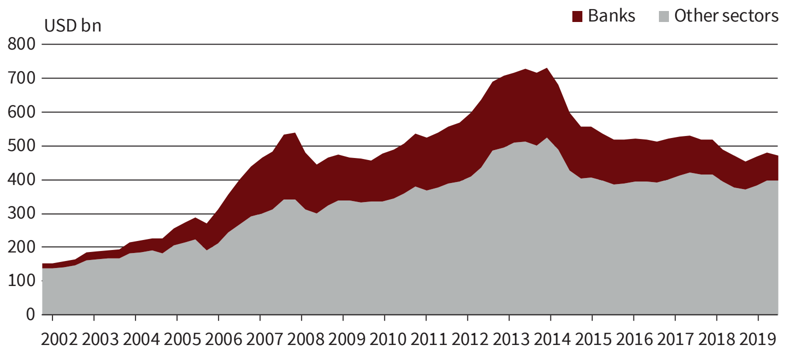
As Western sanctions have also targeted individual Russian companies, Ahn and Ludema (2019) ask whether Russian companies under sanctions performed differently from their peers. Using company-level data they conclude that has indeed been the case. Targeted companies have performed poorly relative to other companies with similar characteristics. For example, their operating revenue falls by one-quarter and their total assets by approximately one-half in comparison to the control group. Targeted firms have also had to cut staff and face a higher probability of going out of business. This result tells us that economic sanctions can be designed in a way that is detrimental to the targets while allowing other companies to operate in a more normal fashion.

One avenue for both company-level and macro effects of sanctions is the availability of finance. Based on many papers discussed in this note, one can surmise that sanctions have worked to reduce investment in Russia. Curtailed availability of foreign financing is most likely one reason for this lackluster investment development.

Figure 2 shows the evolution of Russia's foreign debt. It is clear that the foreign funding of Russian banks in particular has been affected by financial sanctions. The foreign debt of Russian banks peaked in March 2014 at USD 214 billion, thereafter declining to USD 74 billion in September 2019, a reduction of 65 percent. The dominant position of Sberbank and VTB, which are under sanctions, likely accounts for much of Russia's decoupling from global capital markets.

An issue that is not often discussed in the public is that, at least for banks, no other source of external financing has been found. While e.g., foreign direct

Figure 2
Russia's Foreign Debt



Source: Bank of Russia.
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investment from China and India into Russia's energy sector has grown, the Russian banking sector has not found outside debt investors. For many international banks the prospect of being blacklisted by the US Treasury is simply too large a risk to take.

Using partially confidential BIS data, Korhonen and Koskinen (2019) present evidence that net capital flows from the sanctioning countries' banks to Russia declined by USD 700 million per quarter after sanctions more than capital flows from other countries declined. This confirms the discussion about the lack of outside investors.

CONCLUDING REMARKS

Even though the most recent news from eastern Ukraine is somewhat encouraging, it will most likely take several years for all the stipulations of the Minsk agreement to be met. This also means that the lifting of EU and US sanctions is still some ways off. Moreover, the way the United States has introduced many additional sanctions against Russian entities and individuals since 2018 – sometimes almost as if against the wishes of the US president – would lead many to believe that in the immediate future there will be more economic sanctions, not less. This is also true for Russia's countersanctions. As they are now part of Russia's more comprehensive import substitution program, it would be quite optimistic to expect them to be lifted anytime soon.

It therefore appears that Russia and its most important trading partner – the European Union – have in many ways become less integrated as a result of Russia's aggressive foreign policy and violations of international laws. While sanctions have in all likelihood helped to deter a further deterioration of the situation in eastern Ukraine, it is currently difficult to be optimistic about a speedy resolution to the crisis.

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