Russia and Eurasia Programme
Event Summary

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Sanctions on Russia: Economic Effects and Political Rationales

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On 30 June 2015 Chatham House's Russia and Eurasia Programme hosted a roundtable to provide an up-to-date analysis of the sanctions regime that the US and the EU have imposed on Russia since the annexation of Crimea and the subsequent war in Ukraine. The first session addressed the economic effects of the sanctions by closely analysing the macroeconomic impact, the changes in Russian politico-economic policy and how the oil and gas industry is affected. The second session discussed the political rationale for the sanctions, including the West's objectives, the design of the sanctions and their political impact.

Session 1 | Economic effects

The macroeconomic impact

It was argued that in macroeconomic terms, the impact of the sanctions has been quite limited, especially as the economic losses incurred by Russia cannot be linked directly to the sanctions. A mild recession had been predicted as early as March 2014 – that is, before the first wave of sanctions. However, although economic growth did slow down, Russia has so far avoided recession owing primarily to ruble depreciation, which has allowed mass import substitution.

The main effects to date can be summarized as follows:

1. **Reduced access to external capital.** Russia had the same experience after the 1998 and 2008–09 economic crises.
2. **Disruption in targeted areas** – particularly the oil and gas sector and the defence industry. For the latter, however, the main impact has been from the halting of trade with Ukraine rather than from the sanctions. Many crucial parts for military equipment were supplied by Ukrainian companies and Russia has begun to take measures to replace them through domestic production. It is unlikely that those measures will be revoked, although Russia could use such a U-turn as a lever.
3. **The ongoing structural slowdown.** This began in 2010 and has gained pace since the second half of 2014 owing to the fall in oil prices.

One expert maintained that shifting the focus from economic production to financing, investment and consumption suggests a dimmer economic outlook. Russia is witnessing a banking crisis catalysed by the interruption in international lending and thus the National Wealth Fund is now not only the last but the only resort for financing. In addition, the lack of financing has contributed to a significant reduction in both investment and consumer spending: the former fell 4.8 per cent year on year in April and the latter 9.8 per cent. Indeed, the decrease in consumer spending will have a significant long-term effect on the economy.

The outlook is very much dependent on oil prices. The flexible exchange rate allows the Russian government to maintain a current account surplus, but at some point it may be inclined to impose stricter capital controls. The National Wealth Fund is dwindling and it is unclear to what level it would have to fall before the government felt compelled to act. One speaker suggested that US$150 billion would be a red flag.

Over the last year, the 'Russian risk' idea has re-emerged. Companies are now taking the political risk involved in investment much more seriously, as a result of which they may decide not to participate in capital-intensive projects (such as Arctic exploration) even if the sanctions against Russia are lifted. On the Russian side, the increasing politicization of economic relations is apparent: there is a strong, perhaps justified, belief that the fall in oil prices resulted from US leverage, while the decision by both Standard & Poor's and Moody's to downgrade Russia's sovereign rating in February 2015 is thought to have been politically motivated. For many, the picture looks gloom; and within the Russian leadership, the oil-price slide and the spectre of economic recession have evoked memories of the collapse of the Soviet Union.

The oil and gas sector

The future of the Russian economy is tied to the development of the global oil market. Although much of the current fall in oil demand is cyclical, some of it is structural resulting from improved energy efficiency and the use of alternative fuels for transportation. Current low demand means that the global oil market can absorb a prolonged period of sanctions against Russia and a subsequent decline in Russian oil exports. As long as non-OPEC producers refuse to make price-supporting cuts, the decisions on how to address the challenge of rising global supply continue to lie with OPEC.

However, the fall in the oil price has so far been cushioned by ruble devaluation: government expenditures are denominated in RUB, while the bulk of government revenues comes from USD-denominated oil-export contracts. However, based on an average of US$80 per barrel, the federal budget is expected to run a deficit of around 2 per cent of GDP in 2015. The Ministry of Finance has only limited ability to raise new domestic debt to deal with the deficit, while, owing to the sanctions, the US and EU debt markets cannot be tapped for that purpose.

So far, the Russian oil majors remain content with the current situation. The decline in oil prices and the fall in the exchange rate against the dollar have largely offset each other; and thus oil production has, in fact, increased. However, the negative impact of the sanctions can be clearly seen from the threat to investment plans. The recovery of production during the post-Soviet period was largely due to enhanced output at conventional fields and the key role played by joint ventures (JVs) with Western companies. But the expected decline in oil production from onshore conventional fields in Western Siberia was to be compensated for by tight oil production and Arctic exploration. Owing to the loss of access to US technology and capital, such plans are now jeopardized. Moreover, the 90-day maturity period for new debt issued by Russian energy companies stipulated by the EU sanctions poses limits on various types of potential financing.

Rosneft, in particular, faces difficulties owing to its outstanding foreign debt. : One expert suggested that the Russian oil major's short-term debt could be covered by free cash flow and the pre-payments received from the Chinese National Petroleum Company (CNPC) for future deliveries. However, the request to the National Wealth Fund for US$25 billion in state aid suggests that Rosneft does not have sufficient funds either to service its short-term debt obligations or to continue with the capital investments necessary to achieve planned production. In addition, the sanctions raise questions as to whether Rosneft will be able to continue to undertake exploration projects requiring foreign partners, such as in the Arctic, and whether it can fund projects such as Yamal.

Across the energy sector, there have already been severe delays to JVs with Western companies. Those established to explore and develop offshore Arctic fields have curtailed their activities as the technology and services required for such work come under the export controls imposed by the US and the EU. Similarly, the various JVs established by ExxonMobil, Statoil, BP, Shell and Total with Rosneft, Gazprom Neft and Lukoil to develop tight-oil reserves have, in effect, halted all activities because of the sanctions.

The pivot to Asia

At the same time, the sanctions, the oil price and tensions with the West have accelerated the process of establishing an energy ‘pivot to Asia’, which had begun as early as 2008. But there are already tensions between Russia and China over the faster development of energy relations, particularly as China seems to expect all deals to be made on its terms. CNPC clearly prioritizes the development of the Power of Siberia pipeline, whereas Gazprom continues to prefer the construction of a Western route (namely, the Altai pipeline from Western Siberia).

The sanctions have had a significant impact on the energy pivot to Asia, as until recently Russian majors had focused on the Asian LNG market. However, LNG requires high levels of funding and expensive extraction technology, which is supplied by only three to four, mainly US-based companies. Since the sanctions were imposed, Yamal LNG and Sakhalin I have both had difficulty accessing funding owing to the shares of Rosneft and Novatek, respectively, in the projects. If such projects can now be pursued only with Chinese companies, the transaction costs will be much higher. Moreover, the oil price slide has brought down oil-indexed LNG prices in Asia, which has challenged the economics of the high-cost Arctic LNG projects. The Vladivostok LNG project has stalled, too, as it relied on Japanese financing and companies. Because LNG demand in Japan has fallen since the project was launched, there is little commercial rationale to the project.

Currently, crude oil exports to the East are expected to rise; but slowing demand in China, the increasing price pressure on Russian crude grades and the uncertainty about Rosneft’s funding in the future cast doubt on the prospects for crude oil export. Rosneft’s ability to meet the East Siberia-Pacific Ocean pipeline target of 80 billion tonnes per annum by 2018 is particularly doubtful, as the oil major has already reduced investment in its East Siberian production capacity and the delivery of crude oil to Asian markets is increasingly dependent on Chinese investment. Furthermore, Chinese companies are no longer so willing to acquire interests in Russian oil-producing assets because of disagreements over project economics; they view the acquisition of an upstream equity interest as a prerequisite for financing infrastructure development. For their part, EU companies can no longer provide shareholder financing to new Chinese-Russian projects. Meanwhile, US export restrictions apply to any country using equipment built in the US or with US content exceeding 25 per cent. Thus, China would risk being in breach of the sanctions if it used such equipment in its Russian JVs. This means that CNPC may prefer to pursue other investments rather than face that risk.

Non-state affiliated companies

Foreign investment in Russian non-state affiliated businesses was very low even before the US and EU sanctions were imposed – accounting for around 20 per cent of total such investment– owing to low demand for this type of funding. Thus, sanctions have had little impact. However, a recent survey by the Higher School of Economics found that those enterprises that were more technologically advanced and more profitable saw sanctions as posing a greater risk. The pivot to Asia will have a marginal effect only on the private sector as it is largely state-led. Overall, the private sector is expected to be squeezed even further – although its contribution to GDP is still only around 20 per cent.

The impact on the political economy

The impact of sanctions on the political economy is much more evident than is the impact on macroeconomics to date. Just as the sanctions appear to be long-term, so Russia is reacting with long-term solutions oriented towards import substitution and ‘securitization’ of the economy.

It was argued that sanctions do not affect non-democracies to the same extent as they affect democracies. As non-democratic systems are generally oriented towards rent distribution to the elite, they continue to provide for the allocation of resources to the same groups under a sanctions regime, thereby ensuring that political stability is maintained. In this context, the main effect of the sanctions has been the reduction in the *scale* of the profit margin for the elites; for example, the construction costs of the Olympic stadium have recently been lowered, indicating just how large the original expected profit margin was. But for the key individuals targeted by the sanctions, any loss is relative, as their fortunes remain extremely large and the regime has ensured that they are insulated from the effect of the sanctions as much as possible; to take two such figures, Rotenberg and Timchenko have been awarded key contracts, such as the Power of Siberia pipeline and various construction projects. Timchenko has even been awarded a major apple-production contract. However, Russia's elites have been hit harder by the fall in oil prices and the corresponding ruble depreciation than by the sanctions.

At the same time, the regime has reallocated some resources to those groups and sectors that have supported the system, including the military, state employees and the machine-building, fuel, energy and agriculture sectors. Meanwhile, the anti-crisis plan introduced at the beginning of 2015, which revealed the Kremlin's plans for import substitution, makes clear that the aim of the new economic policy is to reach key constituencies in order to uphold the politico-economic system. Thus, elite cohesion has increased, defying the very purpose of the sanctions.

Above all, the impact of the sanctions has been to promote the evolving 'securitization' of the economy. The word 'security' has been mentioned in unexpected areas of economic policy – for example, in reference to the food industry, oil and gas equipment, the pivot to Asia and even the pharmaceutical sector. For its part, the National Security Council has been making key decisions that have an economic impact, despite the fact that the only member of the council who has at least a vague understanding of economics is Prime Minister Medvedev.

This direction in economic policy will continue as long as political tensions persist and the ruble remains weak. However, Russia's ability to get things done should not be overstated. The government has a very poor record of implementing the many hundreds of reforms approved and orders handed down, particularly as regards industrial policy. Indeed, in general, only about half of its policies are ever implemented.

Session 2 | Political rationale

Western objectives

One expert argued that sanctions are a form of 'war by other means', and raised the question about the desired outcome of the sanctions, which can be achieved only if there is long-term political will and consensus on the part of the West. Because sanctions are by nature a tool to be used over the long run, they are unlikely to result in an immediate improvement in the situation in Ukraine. The need to consider all outcomes must be acknowledged.

Domestic political effects

Sanctions tend to strengthen totalitarianism in the short term, and those imposed by the US and the EU have not destabilized the Putin regime so far. Rather, they have provided the Kremlin with an alibi for the economic slowdown, despite its having been evident as early as 2010. It is possible that without those sanctions, the Russian leadership would have been held more accountable for the current economic problems. Instead, the public and the elite have shown they are willing to accept the narrative of Western responsibility and 'rally around the flag'.

While ordinary citizens may find life becoming slowly harder, albeit not catastrophically so, there is deep long-term pressure on sectors such as education and healthcare expenditure. An ageing population and the gradual reduction in the size of the labour force, coupled with the economic slowdown, will result in an unsustainable increase in benefit claimants. This could lead to public discontent, along with diminished labour productivity and general malaise. It was observed that although the potential for labour unrest remains hard to gauge, the Ministry of Internal Affairs has been increasing its preparation to deal with strikes or other such protests, particularly in the industrialized Urals region.

While the sanctions have the potential to force efficiencies into the system by reining in corruption and embezzlement among the elites, there has been an increase in low-level predatory corruption, which has adversely affected small businesses and innovation.

The sanctions have also had the impact of grinding down the middle class. As a result, emigration has increased from a group that was regarded as the best hope for exerting pressure for reform. This 'brain drain' is especially affecting those educated in the West, who are among the few dissenting voices over Crimea. However, the true extent of popular support for the regime is hard to discern owing to the lack of organized and articulated alternative opinion.

Effects on Ukraine

It is important to view the situation in Ukraine as the country's struggle for itself rather than through the prism of the West vs Russia. Indeed, the West has been seen to be too weak in its support of Ukraine, accepting its inherent vulnerability and attempting to affect the wider decision-making context instead of focusing on rebuilding its economy.

While there is a desire in the Kremlin for the sanctions to be lifted – both to relieve the economy of their impact and to secure Western acceptance – that outcome is not being sought at any price. Although the sanctions have taken their toll on EU member-states, it seems that Germany, in particular, is more determined than ever to continue with the current policy and uphold the sanctions. In December 2014 many businesses thought that they would be able to lobby successfully for the lifting of the sanctions by summer 2015; but it now seems that the sanctions have been generally accepted. Given the moral aim of the sanctions, which reflects the West's obligation to adhere to its own value system, the result is likely to be a long-lasting impasse. Thus, Crimea may come to be viewed as a longer-term problem.

Russian actions in Ukraine appear to have been driven by general aims rather than a definite strategy. The ease with which Crimea was annexed led directly to the events in Donbas. Economic and political control in Donetsk and Luhansk remains unstable, meaning the region is not viable as a frozen conflict zone. Nonetheless, Donbas is considered an irksome but bearable medium-term expense for Russia owing to its ability to channel resources to the region. Accordingly, Putin may wait until Western interest is redirected elsewhere and then use a loose interpretation of the poorly constructed Minsk II agreement to extricate himself from its obligations.

Sanctions design

The sanctions must maintain legality and legitimacy. Indeed, questions have arisen about the legitimacy of sanctions applied to Lukoil, which is not state-owned. The need for economic sanctions to be calibrated and targeted was stressed by some participants; and it was suggested that more could have been done regarding sanctions aimed at individuals. In particular, the potential for targeting individuals residing or holding substantial assets abroad was emphasized. Such an approach would have served to counter the Kremlin narrative of the West's targeting all Russian citizens and would have sent a more positive message to the Russian people.

Finally, it was noted that while many of the sanctions are regarded as convenient and based on the lowest common denominator, they provide evidence of EU unity and resolve and thus may have a significant psychological effect on the Russian administration.