

Sanctions on Russia: Do they work?

Research Report

March 12, 2015

International Analysis Dept.

Senior Analyst Anton Goroshnikov

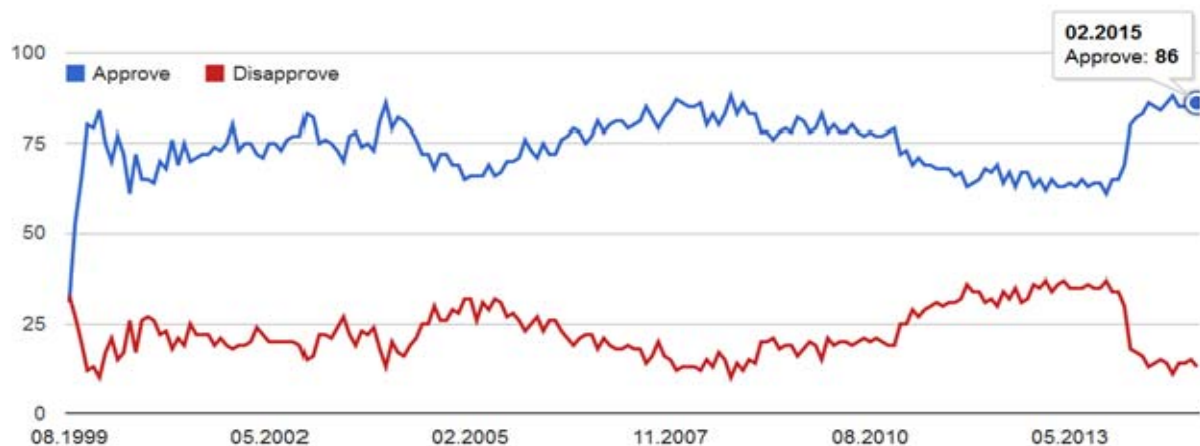
1. Summary:

Western sanctions had a considerable impact on Russian economy, but they failed to reduce Putin's popularity at home and change his course on Ukraine. On the contrary, the Kremlin now has some leverage for tightening screws over the opposition, as a sense of nationalism and pride among the Russians is growing.

2. One year under the sanctions

A year ago, US, EU, Japan and several other governments imposed political and economic sanctions on the Russian Federation, in response to annexation of Crimea, and alleged military intervention into eastern Ukraine as well as downing of Malaysia Airlines MH-17. The main idea behind this was to discipline Moscow for the Ukrainian conflict, which was not totally created by Russia, increase the economic pressure on Vladimir Putin, aiming to force him to change the course and ideally create discontent among the Russians with the current regime, which will urge Putin to step down from presidency in the future. Paradoxically, at this moment, despite plunging ruble and falling oil prices, Putin is still quite popular at home. According to the latest poll, some 80% of Russians with firm political preference say they would vote for Putin at the next presidential elections in March 2018. Putin's latest approval ratings are still quite high and in spite of growing criticism and pressure, he is still considered to be the most powerful politician in Russia and a very influential, though quite "controversial" figure in the modern international political arena.

Approval of Putin



Source: Levada Center

While the fallout of Western sanctions was felt by a vast majority of Russians, only one in five thinks that Moscow should reconsider its policies towards Ukraine. More than 80% of Russians still support "unification" of Crimea with Russia and surprisingly, 93% of Crimeans also seem to be happy with the last year's inclusion in Russia, according to a recent Ukraine-Germany independent telephone poll survey¹.

¹ Bloomberg (February 6, 2015), "One Year Later, Crimeans Prefer Russia"

<http://www.bloombergvew.com/articles/2015-02-06/one-year-later-crimeans-prefer-russia>

3. More sanctions needed?

So, do the sanctions work? And, are they effective enough to change Russia's behavior in Ukraine? ! The picture here seems to be quite mixed and there is no clear answer to this question. There are several arguments for further extension and even expansion of the sanctions against Russia, as well as opposing arguments, that this will only lead to further escalation of the conflict and spark additional counter-sanctions from the Russian side. While the most critical external threat to the Russian economy in the future will be the falling oil prices, Western sanctions have exacerbated chronic problems in Russian economy, such as high dependence on foreign capital and technology. Russian banks and companies have already started to feel the pain, since they are now barred from the Western financial markets as a result of the sanctions. Many are shifting cash from US dollars to Hong Kong dollars and depositing them in Chinese banks².

Needless to say, sanctions have seriously damaged the already quite weak Russian international investment image; last year's FDI flows to Russia were estimated to have fallen by 70 percent, although the country significantly improved its position in the "global ease of doing business" ranking, published by the World Bank.

Still, there is an argument that the sanctions have in fact been very helpful for Russia, as they have encouraged import substitution in some industries such as foodstuffs, as well as in the production of durable goods, such as furniture. Russian steel makers and coal export companies also seem to have benefited from the ruble's decline as many of them start to increase export to Asian market³.

Moreover, it is also very important to note that the sanctions are pushing Russia into Chinese arms; Russian authorities, now consider granting Chinese investors over 50% stake in Russian strategic hydrocarbon fields. Russia's trade dependence on China is growing, and the two countries are also increasing their security and military cooperation (arms sales, technology transfer), which can seriously dent the power balance of the Asia-Pacific region in the future.

On the other hand, it is argued that sanctions hurt not only the Russian economy, but it also has a dramatic impact on European exporters in an already fragile economic environment⁴. Since, Russia is still the leading trading partner to EU, additional sanctions will only worsen already tense business relationships between Russia and EU⁵.

To sum up, the sanctions certainly had an economic impact on Moscow, but it was just one factor behind the Russian economic crisis and ruble's collapse. Moreover, sanctions helped Putin domestically by uniting Russians behind him and this will give the Kremlin some leverage for tightening the screws at home; only a few Russians agreed with the demands of opposition politicians or said that they would like to see those people in power one day. However, as Russian history suggests, patriotism in Russia might not last long if there is no real economic prosperity. Russian empire collapsed in 1917, mainly because of economic problems, although initially there was a great patriotic wave of Slavonic pride and jubilation over going to war with Germany. USSR crumbled after its economy collapsed in the 1980s, and liberal democracy in the 1990s also bankrupted after reforms failed to yield economic dividends.

So, how long can Putin withstand lower oil prices and economic sanctions in the future? This is a good question to ask as Russia prepares to spend another year under the Western sanctions.

² Bloomberg (July 31, 2014), "MegaFon Shifts Cash to Hong Kong Dollars on Sanction Risk"

<http://www.bloomberg.com/news/articles/2014-07-31/megafon-shifts-cash-to-hong-kong-dollars-on-sanction-risk>

³ Nikkei Asian Review (February 27, 2015), "Russia pulls down Asia steel, coal prices"

<http://asia.nikkei.com/Markets/Commodities/Russia-pulls-down-Asia-steel-coal-prices>

⁴ FINANCIAL TIMES (November 26, 2014), "German businesses suffer fallout as Russia sanctions bite"

<http://www.ft.com/intl/cms/s/0/d1f4d81c-7160-11e4-818e-00144feabdc0.html#axzz3TTtKefLH>

⁵ It is interesting to note that, in spite of deepening tensions with the US over Ukraine, US-Russia foreign trade volume is actually increased in 2014 by 7%.