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Policy brief

Impact of Sanctions on Russia:

An Assessment

Ben Aris

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Iranian–style sanctions will not work on Russia. As the world's largest oil exporter and supplier of a third of Europe's gas, cutting off Russia's energy export products is not an option. Reducing the flow of energy from Moscow would hurt Europe as much as it would hurt Russia. The countries closest to Russia are 100% dependent on Russian energy and their factories would simply grind to a halt.

Russia's rise as a consumer market is also significant. In 2013 Russia became the largest market in Europe for toys and milk, and this year it is due to become the biggest market for clothes, footwear and apparel. Each year – it takes the number one slot in another consumer category and as soon as 2018 Russia will simply be the largest consumer market in all of Europe, period. Although western investment into Russia remains low on a per capita basis it is already a major contributor to the bottom line of an increasing number of European firms – mostly in retail, but increasingly in other sectors such as engineering, banking and high-tech.

The interests of America and Europe in this regard are vastly different. America exports virtually nothing to Russia and has virtually no investment in Russia. The same is not true for the Europeans – and doubly so for the Germans. Germany has 10 times the number of firms invested into Russia compared to other European countries – over 6000 German firms are working in Russia today and they have been reinvesting every penny they make into expanding as fast as they can.

Other European powers – notably Italy and France – are also committed to growing their Russian businesses. It is notable that at the beginning of June the World Bank made its first loan to a company operating in Russia since the annexation of Crimea in May: it lent the French retailer Auchan $250 million to continue its expansion. And that is not to mention the French government's decision to go ahead with the sale of the Mistral warships to Russia's Navy, in defiance of Washington's wishes.

While European leaders, such as German Chancellor Angela Merkel, have publicly come out in support of Washington's line on sanctions, very little has been done in the way of actually ratcheting up the pain of sanctions, which are stuck at a symbolic level. Clearly Europe is going to talk the talk as demanded by Washington, but when it comes to the walk it's going in a different direction. This is already creating tensions between Washington and Brussels and the bottom line is that punitive sanctions – the so-called phase 3 sectoral sanctions – will never be imposed because of the economic cost to a still wobbly European economy.

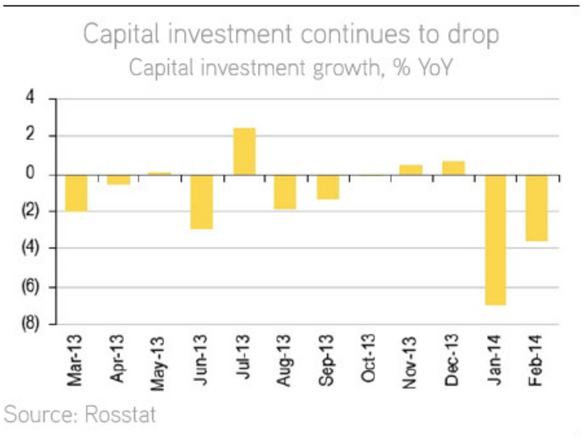
The cost of sanctions would also wreack havoc in the rest of the Commonwealth of Independent States (CIS) and precipitate a crisis that no one wants or can afford. At the European Bank for Reconstruction and Development (EBRD) annual meeting in Warsaw in May, the EBRD's chief economist Erik Berglof pointed out that countries such as Armenia and Tajikistan are heavily reliant on remunerations from Russia – guestworkers in Russia send money home to Tajikistan to the equivalent of half of GDP. Imposing sectoral sanctions on Russia will immediately see the smaller and weaker states in the CIS collapse. It would also cause severe economic damage – indeed just the threat of sanctions -- is already causing economic pain in central Asia and Southeast Europe, such as in Bulgaria and Kazakhstan.

As a result, so far sanctions have been purely symbolic: the equivalent of one bus full of oligarchs has been directly affected but the sanctions applied to these friends of Vladimir Putin have not been applied to their companies. The direct impact of sanctions is therefore limited to say the least.

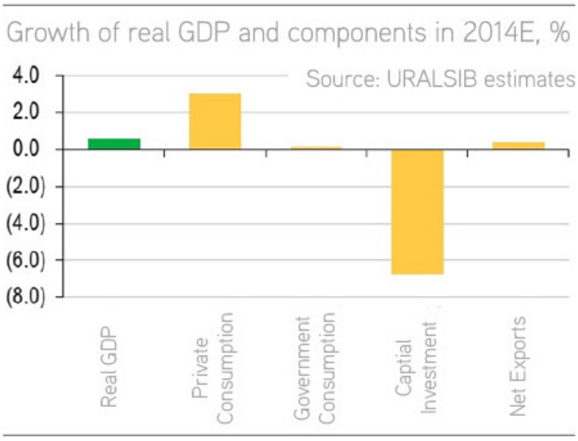
Indirect impact

The same is not true of the indirect effects of the threat of financial sanctions. These have had an enormous impact on Russia's economy. Business New Europe has estimated that the cost to the Russian economy of threatened financial sanctions is in the order of $400 billion in lost revenue, lost investments, and economic slowdown – and that is before you take into account the additional Russian investments needed in Crimea and all the costs of the military campaign there.

The damage done is largely self-inflicted: 2014 was supposed to be the year when the Russian economy began to recover from the 2008 crisis. However, instead of growing, the economy has slowed even more, and is now on the verge of stagnating. The main issue is the lack of direct investments by Russian domestic companies into their own economy and businesses. Capital investment needs to be at least 25% of GDP if the economy is to grow, but in the last few quarters investment has actually been shrinking and is currently about 20% (See Graph 1). Estimates for GDP growth this year have fallen continuously and are now somewhere between zero and half a percent (See Graph 2).



Graph 1



Graph 2

The flip side of the same coin is the soaring capital flight. Most of the boom in the pre-2008 crisis period was driven by Russian money returning home. The opportunities in the domestic economy were enormous and Russians began to invest in expanding their own businesses. However, the showdown with Washington has unsettled domestic businessmen who have been fleeing the country again and stashing cash in offshore havens. This trend has been exacerbated by Putin's launching of the first real anticorruption drive of his 14 years in power. Capital flight was expected to slow this year. Hhowever it has accelerated: almost as much left in the first quarter of this year as left in all of 2011.

Oligarchs and legitimate domestic Russian businesses are equally scared that financial sanctions might be imposed, the one place Russia is really vulnerable to US pressure. Russia operates the only completely open capital account of all the major emerging markets in the world: money flows in and out easily and without restriction. However most of Russia's trade is denominated in dollars and therefore they are especially vulnerable to the threat of US financial sanctions.

Acknowledging this, the Kremlin immediately moved to set up its own national payment system in May. VISA and MasterCard were threatened with new rules that would require them to deposit as much money as they turn over in the year as a guarantee for payments to Russian customers. In the next two years Russia hopes to set up its own national payment system, which will operate in rubles. As a rider to this aspiration, the recent $400 billion gas deal signed with China in May will also be settled in yuan and rubles.

Although Russia is vulnerable to the dollar, one of the results of the showdown with the West is to accelerate the move of major countries (not just Russia) away from using the dollar as the international settlement currency; there will now be a diversification away from the dollar that cannot be stopped and this will ultimately undermine America's political and economic power.

Pivot to the east

The Kremlin has also sought to manage the downsides by hitching its wagon to the fastest growing economy in the world: the Sino-Russia synergy has been called the best on the planet as Russia has the raw materials while China has both the consumers and the cash.

But the alignment with China is operating largely at a political level. The Sino-Russian deals are typically struck between large state-owned enterprises. This has the result of concentrating even more political and economic power in the state and state-owned companies. This will slow and harm reform efforts. In order to drive investment Russia needs to encourage private enterprise as only private commerce will allow the economy to flourish. Instead what is likely to happen over the next decade is the state companies will continue to dominate and be the major source of income for the Russian economy. This means that Russia will continue to grow, it will continue to make money, but it will fall short of reaching its potential.

Domestic politics

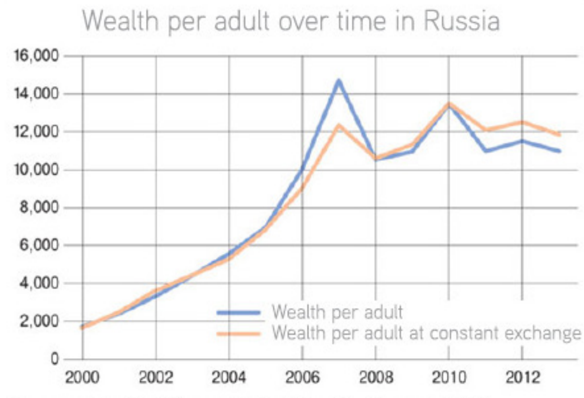
By far the most significant impact of the current political crisis over Ukraine and relations with the West, however, is the dramatic effect it has had on Russia's domestic politics. In December 2011 Moscow saw the first large-scale street protests in more than a decade. Voters were outraged at the vote rigging that went on as part of the Parliamentary elections. Opposition leaders emerged and began to whip up popular sentiment, launching the first real challenge Putin has faced since taking office in 2000.

The annexation of Crimea in May was a pivotal moment. Russians – both liberal and conservative – welcomed the return of the Crimea to the Russian motherland. Crimea was given to Ukraine on a whim by party chairman Nikita Khrushchev in 1954 and most Russians still consider it to be part of Russia's sovereign territory. But the real significance of the annexation was not reclaiming Russia's favourite holiday resort but the success of the Kremlin which had gone toe to toe with Washington and won. For Russians this marks, maybe not return to superpower status, but certainly an end to the humiliation that Russians have felt in the last 20 years since the collapse of the Soviet Union. For the man on the street Russia has returned as a major player on the international stage and Russians are nothing if not proud.

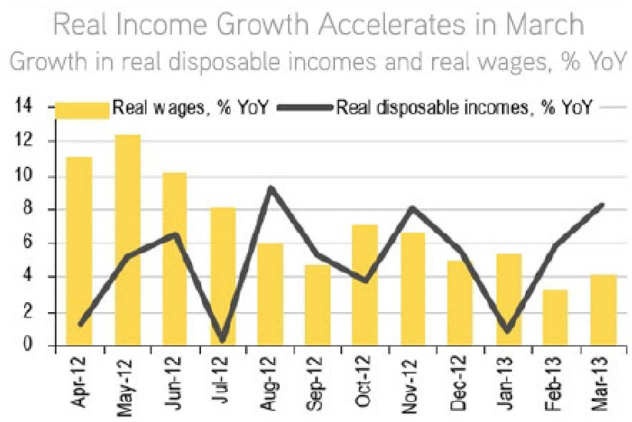
Even amongst the nascent oppositional movement only one liberal deputy voted against the annexation of Crimea. Putin's popularity has soared to an all time high of over 85%, in recent polls.

The irony is that with the economy slowing rapidly for the first time Putin was actually politically vulnerable to the opposition. His popularity had been

Graph 3



Source: Credit Suisse Global Wealth Report 2013



Source: Rosstat

Graph 4

predicated on the prosperity that he has delivered (see Graphs 3 and 4). In Yeltsin's era the average income was around $50 a month but since Putin took over incomes have soared 16-fold. The stand-off over Ukraine has now handed him an extremely popular nationalist platform that he has made full use of. Happily for Putin, despite the economic slowdown, the pain has also not been felt on the street as average incomes have continued to rise throughout the crisis years.

Any chance of ousting Putin has now disappeared and the opposition have been made a total irrelevance. This too will lead to more concentration of political power in the existing Kremlin structures. As meaningful sanctions have yet to be imposed and almost certainly will not be, and notwithstanding the effects of the threat of financial measures against Russia as outlined in this paper, the change in the domestic political landscape in Putin's favour is probably the biggest single consequence of the confrontation over Ukraine and the imposition of western sanctions on Russia to date.

About the Author

Mr. Ben Aris serves as Editor-in-Chief at Business New Europe. He is an Eastern Europe specialist. The third longest serving foreign correspondent in Russia, he lived and worked in Moscow between 1993-2003, where he was bureau chief for the Daily Telegraph as well as a contributing editor at The Banker, Euromoney and The Business. He is also a regular contributor to many of the best-known international business titles such as The Wall Street Journal, The Financial Times, Institutional Investor and many others. In 2003, He moved to Berlin as acting bureau chief for the Guardian before founding Business New Europe and covering all of CEE, although his main focus remains Russia.

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