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Western Economic Sanctions and Russia's Place in the Global Economy

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The Ukraine crisis and the imposition of economic sanctions by Western powers and their allies have the potential to cause a radical shift in economic policy in Russia, with important implications for Russia's future place in the global economy. This is because Western economic sanctions and Russia's response to those sanctions have set Russia on a course towards greater isolation from the Western parts of the global economy, and towards greater state control of economic activity at home. This chapter considers the effects that Western sanctions have had to date, and what they might mean for the future of the Russian economy. The first section provides a brief description of the sanctions regimes put in place by Western powers and Russia over the course of 2014. A second section considers the immediate impact that these sanctions have had upon the Russian economy. A third section explores some of the possible effects that sanctions may have upon domestic political economy in Russia. A fourth and final section considers the possibility of a Russian economic 'pivot' to Asia.

Economic Statecraft by Russia and the West

Economic statecraft refers here to the economic measures employed by Western powers, their allies, and Russia as instruments of foreign policy, especially in relation to Russia's role in the conflict in Ukraine (Baldwin, 1985; Hanson, 1988). In addition to measures targeted at individuals, Western countries imposed a range of so-called sectoral sanctions. They include: 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 largest state-controlled banks (including Sberbank and Gazprombank), three Russian energy companies (including Rosneft, Transneft, and Gazprom Neft, although not Gazprom, which has been subject to US sanctions), and three Russian defence companies (OPK Oboronprom, United Aircraft Corporation, Uralvagonzavod); a ban on loans to five major Russian state-owned banks: Sberbank, VTB, Gazprom Bank, Vneshekonombank (VEB), and Rosselkhozbank; an embargo on arms trade between EU members and Russia; a ban on exports of so-called dual-use items, i.e. civilian industrial goods that can be used as (or to produce) weaponry or for other military purposes; and a ban on exporting certain energy equipment and providing specific energy-related services to Russia's most technology-intensive oil exploration and extraction projects (e.g. Arctic deep-water exploration and onshore tight oil).

In response, Russia imposed its own counter-sanctions. While a range of different counter-sanctions were applied by Russia from March 2014 onwards, the most economically significant sanctions were applied in August 2014, with the one-year ban on imports of fruit, vegetables, meat, fish, milk, and dairy from all EU countries, as well as additional Western countries, including the USA, Norway, Australia, and Japan.

Immediate Effects of Economic Sanctions

Western governments targeted three sectors with the sectoral sanctions regime devised in the summer of 2014: the defence industry, the oil industry, and the financial sector. Thus far, the effects have not been uniform, with only the financial sector experiencing any significant effects to date.

Output in the defence industry rose in 2014, despite sanctions, due to growing demand from abroad (in 2014, Russia was the world's second largest exporter of armaments) and from at home (i.e. due to the rise in procurement that was planned as part of the State Armaments Programme to 2020 [*GPV-2020*]) (Rosstat, 2014). Although Russia had some important defence ties with some Western countries, the vast majority of its exports go to countries in Asia, Africa, and Latin America. Consequently, such sanctions should only have an impact over a longer period if military-use technology transfers from the West to Russia are suppressed, and if this then results in a degradation of the Russian armaments industry.

Sanctions have not affected production levels in the oil industry, either. Instead, output has continued to rise, reaching a post-Soviet record of over 10.6 million barrels a day in November. This is because Western sanctions are not designed to affect production levels in the immediate future. Rather, they are designed to affect future production in Russia's newer, harder-to-reach deposits in the Arctic, off-shore and in Russia's Bazhenov tight oil deposit.

Sanctions on the financial sector have exerted a more immediate impact on the Russian economy. Access to Western capital markets is now largely closed to most Russian corporations, forcing many Russian firms to repay their external debt ahead of schedule due to the impossibility of refinancing or 'rolling over' their credit lines. Total non-financial corporate (which includes many large state enterprises, such as Rosneft and Gazprom) and financial sector external debt amounted to around $610 billion in September 2014 (CBR, 2014). At the prevailing exchange rates in December 2014, this amounted to over 60 per cent of GDP. Of this, nearly $130 billion is scheduled for repayment before the end of 2015, raising the prospect of Russian firms scrambling to secure scarce dollars to service their external debt (CBR, 2014). While this is causing some discomfort for many firms, it is also true that most of the firms with foreign currency-denominated external debt are natural resource exporters who also generate substantial foreign currency revenues, which should enable them to service their debt obligations.

Russia's own counter-sanctions have yet to have any observably positive effects in the form of a significant increase in output in the agricultural sector. This is probably because producers in those sectors that Western producers were most active, such as pork, beef, and dairy products, as well as specific categories of fruit and vegetables, have traditionally been inefficient. Indeed, it was precisely these sub-sectors that proved resistant to accession to the World Trade Organisation in 2012 due to fears that they would not be able to compete with foreign producers (Connolly and Hanson, 2012). This has meant that domestic production has not risen dramatically, as some initially hoped. Instead, exporters from countries that have not participated in the Western sanctions regime, such as Argentina, Brazil, China, Chile, and Turkey, have all benefited by increasing their share of the Russian food market. The prospects for food production in the affected sectors may be brighter: government policies to promote the development of domestic producers through a state-led import substitution strategy are being devised, and may involve an expansion of subsidies and other forms of state support.

The costs associated with the imposition of the agricultural counter-sanctions are borne by Russian consumers. The cost of food forms a large proportion of the typical household budget. As a result, any price rises caused by the food embargo are bound to have an immediate effect on Russian consumers. To date, food prices have risen, nudging Russia's end-of-year consumer price index (CPI) towards double-digit levels, with the price of banned products rising considerably faster than average (Rosstat, 2014). However, the embargo appears to be hitting middle-class, urban consumers more than most due to their propensity to consume imported food products to a greater extent than poorer sections of the population.

Finally, the fact that the Russian economy appears to be slowing down at the same time that sanctions have been applied has created the impression that sanctions are *causing* growth to slow. The rapid depreciation of the rouble in late 2014 reinforced this perception. However, such an interpretation conflates correlation with causation. The

Russian economy was already in the midst of a protracted reduction in the average annual rate of GDP growth before the Ukraine crisis. Western economic sanctions may have exacerbated a pre-existing trend, but the effect has been modest. Instead, the appreciation of the dollar against all major currencies and, more importantly, the precipitous decline in oil prices over the course of the second half of 2014 provide a more accurate explanation for the depreciation of the rouble and the deterioration in business confidence that was evident towards the end of the year (Connolly, 2015).

To sum up so far, the economic effects of the economic statecraft that has accompanied the Ukraine crisis have so far been relatively modest. This is to be expected. After all, official statements from Western governments do not indicate that sanctions are intended to cause a slowdown in overall Russian economic performance. It is important, however, to try, insofar as is possible, to separate the effects of sanctions from the effects of pre-existing ailments afflicting the Russian economy. Without making this distinction, it is possible to fall into the trap of asserting that Western powers are responsible for any deterioration in Russian economic performance, an argument that is increasingly and misleadingly deployed by both the authorities in Russia and by some commentators in the West.

Longer-Term Effects of Sanctions

If the economic effects of economic statecraft are relatively modest, the long-term effect on the trajectory of political economy in Russia could well be more profound. Assuming that the sanctions regimes stay in place for a period of years rather than months, it is useful to consider how this might shape the model of political economy in Russia.

The longer sanctions persist, the more the market-oriented (i.e. liberal) policy elite – hitherto well entrenched in Russia's key economic policy positions in the Ministry of Finance and Ministry of Economic Development, as well as the Central Bank of Russia – is likely to be marginalised. This appears to be the case thus far. Economic statecraft has meant that economic policies that are consistent with a more *dirigiste* and introverted economic policy are becoming increasingly popular. Already, import substitution is being promoted across different sectors of the economy, most notably in defence, energy, manufacturing, and agriculture – the key sectors of the Russian economy. 'Soft' capital controls are in place to regulate the sale of foreign currency from Russia's largest enterprises, and the state is intervening in the financial sector to maintain financial sector stability (Finmarket.ru, 2014). Under such conditions, sections within the Russian elite in favour of even greater military spending and state-led modernisation will likely become emboldened at the expense of the more liberal, 'economic' bloc within the elite. Over time, this may result in the state using its dominant position in Russia's 'commanding heights' to raise the rate of investment in the economy through the use of state-directed lending to selected 'strategic' enterprises.

Sanctions may thus serve to entrench the current system of governance rather than weaken elite support for Putin. This could happen because sanctions have specific distributional effects in oligarchic societies like Russia, and can serve to bolster the state and enrich politically important individuals and organisations (Brooks, 2002). The leadership may use the opportunity presented by the deterioration in relations with the West to transfer economic resources to key political allies.

To illustrate this point, consider how Russia is currently responding to the embargo on the sale of Western defence or dual-use technology to Russia, and to the severance of trade relations with Ukrainian defence enterprises. While supply chains have been interrupted, this has offered the leadership the chance to shift more resources to develop the domestic defence industry instead. Already, programmes to produce substitutes for items previously imported from Ukraine and the West are being drawn up that will require the allocation of significant state resources.

Such import substitution strategies are unlikely to be efficient from an economic point of view, as it is unlikely that Russia will produce goods as efficiently or to the same standard as Western firms any time soon. But from a political perspective, the diversion of extra resources to the domestic defence industry would create a constituency that benefits from sanctions. In the context of Russia's ongoing rearmament programme, this outcome could further increase defence industry support for the current leadership.

Similar effects are likely to be observed in the energy industry. It is widely acknowledged that Russia will require access to foreign technology and know-how in the future if it is to exploit the geologically harder to reach oil and gas deposits in the Arctic and the Far East. But because the existing sanctions regime is designed to deny Russia the tools to do this, the government might opt to expand direct state ownership of the industry, and form partnerships with state-owned companies from friendlier countries (China, for instance) to develop indigenous industrial capabilities to replace Western technologies.

Again, such a solution would not be as economically efficient as current arrangements to access technology and know-how through joint ventures with the likes of BP and Exxon-Mobil. But those charged with managing an energy industry dominated even more by the state than it is now would arguably become even more powerful, not less. As with the defence industry, such import substitution policies are likely to be politically efficient, if not economically efficient.

Taken together, the trajectory of Russia's reactions to economic sanctions only briefly outlined here are pushing it away from the path of reintegration with the global economy that she has undergone over the course of the last twenty years. Instead, a self-sufficient, quasi-autarkic relationship with the global economy may emerge. Although Russia would remain far more open than it was during the Soviet era, it would be a deeply worrying step backwards for those hoping the country would become an open and active part of the global economy. Domestically, the creeping accumulation of measures that expand the role of the state in the economy – from 'soft' capital controls to the wide range of import substitution policies that include financial support and measures to suppress competition – threatens to create a more overtly *dirigiste* system of political economy that exists at present.

A Pivot to the East?

The final element of Russia's reaction to Western economic statecraft is its stated aim of intensifying its economic and political relations with Asia, especially China. Even before the Ukraine crisis, Putin, apparently taking a leaf out of US President Barack Obama's book, announced a new 'pivot to Asia' strategy, in the hope that Russia will be able to leverage the perceived economic dynamism of countries like China and South Korea to its advantage (Lo and Hill, 2013). Many within the Russian elite feel that Asia, and especially China, is a more dynamic economic region than the West, and one that comes with less political baggage.

An Asian pivot has other advantages. In particular, it is viewed as providing a rationale to boost the development of Russia's Far East. Although the region is full of valuable natural resources, it suffers from a sparse and declining population and a neglected economy. Developing the region would, like it did under Soviet rule in the 1960s and 1970s, require considerable state involvement. Again, powerful constituencies from within the Russian elite would likely benefit from any state-led development project in the Far East.

Therefore, any moves towards greater integration with the Asia-Pacific economy should be viewed as connected to wider tendencies towards greater state involvement in the economy. Indeed, the agreements on greater cooperation between Russia and China signed in recent years, and including the much-celebrated gas deal apparently formulated in May 2014, are typically agreements between state and quasi-state entities on both sides. This pattern of state-centric relations is surely more appealing to the Russian leadership than the more market-based relationships required for closer relations with Western economies.

However, there are some important obstacles to any planned Asian pivot. On the one hand, Russia's trade relations with Asian countries, and especially China, have grown rapidly in recent years. In 2000, the northeast Asian trio of China, South Korea, and Japan accounted for just 5.5 per cent of total Russian imports (UN Comtrade, 2014). By 2012, this figure had grown to 25 per cent. Russian exports to the region also grew, albeit at a slower rate. In 2000, the three Asian countries accounted for 7.5 per cent of total Russian exports; by 2012, this had grown to 12.5 per cent.

On the other hand, the paltry level of Asian investment in Russia also reveals serious gaps in economic integration. Even after a number of high profile energy and infrastructure deals, China, South Korea, and Japan collectively account for just over one per cent of foreign direct investment in Russia. So while Russia may be importing a growing volume of goods from Asia, it still turns overwhelmingly to Europe for capital.

Second, Russia needs to invest in costly infrastructure in its Far East (roads, railways, pipelines, and so on) if it is to fully engage with Asia's growing economy. Any such spending will require massive private and public investment, and it is far from clear whether such spending will materialise. If it does, it is likely that resources will come from the Russian state, adding yet more substance to the reassertion of the state in the Russian economy.

Third, the growing asymmetry between Russia and China may be even more important. Quite simply, the Russian economy is dwarfed by China's and the gap between them is growing. While the prospect of closer ties with its largest neighbour offers a tantalising prospect – an economic and political counterbalance to the West at a time when relations with the US and Western Europe are at a 20 year low – the Chinese are not under any such pressure. Russia is a relatively minor trade partner, accounting for just over 2 per cent of China's total trade. With Russia's relations with the West deteriorating, it is more likely China will exploit Russia's relative isolation and secure more favourable terms in any deals.

Overall, while pivoting to Asia might be desirable in principle to Russia's ruling elite, the reality of the situation is that Europe will continue to be Russia's main source of trade and capital, as well as technology and know-how, for the foreseeable future. Moreover, should the Russian state intensify efforts to accelerate the strengthening of economic ties with Asian economies, it is likely that centralised economic development of Russia's Far East will be the order of the day, rather than any natural, market-based switch. As a result, expansion of trade with Asia is likely to be built on state-to-state relations with China and India in the areas of energy and defence.

Conclusion

As should now be clear, Western economic sanctions are moving Russia away from a model of economic development approximating the Western model, i.e. based on the primacy of the market and openness to the global economy, or at least the Western-dominated parts of the global economy. In its place, policy-makers are slowly constructing a system that eschews market-based solutions to economic development problems, and which favours selective integration with the global economy, with a preference for other state-driven political economies. The leadership in Russia is, in line with many previous Russian governments throughout history, using the presence of an external threat to justify centralisation of the model of political economy at home. This model is beginning to take shape, and involves the suppression of economic competition, state control over the 'commanding heights' of the economy, especially finance, energy, and defence, and the deterioration of the business environment for the market-based portions of the Russian economy. In short, such a model threatens to roll back many of the more positive elements of Russian economic transformation that have taken place since 1991.

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