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EVALUATING WESTERN SANCTIONS ON RUSSIA



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Cover photo credit: Reuters/Thomas Peter. An armed member of a local self-defense unit watches traffic at a checkpoint on the highway between Simferopol and Sevastopol in the Crimean peninsula, March 13, 2014.

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INTRODUCTION

It has been more than two years since the European Union (EU) and the United States (US) imposed economic sanctions on Russia for its aggression in Ukraine. For some of the measures, though not all, that is time enough to evaluate effectiveness. But before such an assessment can be made, the initial goals of the sanctions should be clearly stated. This is not as straightforward as it might seem.

United States Assistant Secretary of State, Victoria Nuland, told a Senate panel in June 2016 that sanctions were meant to “press Moscow to bring an end to the violence in Ukraine and fully implement its commitments under the Minsk [ceasefire] agreements.”¹ By that standard, they have failed. The situation in eastern Ukraine today is one of low-intensity warfare rather than a ceasefire. And what of the first wave of sanctions imposed in March 2014 as punishment for Russia’s military takeover of Crimea? Were they meant to pressure the Kremlin into relinquishing the peninsula? To anyone familiar with Russian President Vladimir Putin’s foreign policy strategy, this would have seemed far-fetched.

Still, there are intermediate goals, not simply full compliance, that this report considers: to contain Russia’s adventurism and to craft a cautionary tale in which Russia pays a high price for—and the West takes a principled stand against—the Kremlin’s violation of international law and its neighbor’s sovereignty. By these measures, Nuland told the Senate Foreign Relations Committee, the medicine is working. “These sanctions, combined with low oil prices and Russia’s continued structural weaknesses, have imposed significant costs. While Moscow has not yet changed its approach to Ukraine, our readiness to toughen sanctions even further has likely played a role in deterring further Russian efforts to grab Ukrainian territory.”²

Even if the West had faced a different Russian leader, the first wave of sanctions, imposed after the annexation of Crimea, were never going to result in the withdrawal of Russian troops from the peninsula. Initially limited to asset freezes and visa bans on those with a role in the annexation, they also did not

stop Russia from sending troops and weapons into the Donbas immediately following the annexation or violating the first Minsk-1 ceasefire agreement, signed in September 2014.

It may be correct, as Nuland said, that sanctions have deterred more “Russian efforts to grab Ukrainian territory.” But even the far reaching sectoral sanctions that were imposed after the Kremlin’s actions in eastern Ukraine, which targeted key Russian industries, businesses, and banks, failed to get Moscow to hold up its side of the Minsk-2 ceasefire agreement, reached in February 2015.

As for imposing economic costs on Russia, sanctions against specific individuals persuaded some of the targeted individuals in Putin’s inner circle to sell major assets or transfer them to relatives. As to the economic impact of broad financial sanctions, instituted in July 2014, this too has been limited. The lack of access to capital markets as a result of the sectoral sanctions combined with the drop in oil prices surely contributed to the collapse of the Russian ruble in December 2014. In addition, according to most estimates, sanctions may account for a decline of 0.5–1 percent of Russian gross domestic product (GDP) in 2015. In the long term, a ban on the transfer of certain technology and expertise to Russia, combined with the possibility of further sanctions, could mean that the political risk of doing business in the country, along with Russia’s technological isolation, will continue to grow, with obvious negative implications for its economy.

The sanctions’ greatest achievement is that they have been an important demonstration of transatlantic unity. The coordination of sanctions between twenty-eight EU countries and the United States is a signal foreign policy achievement, sending a clear message to Putin that the West will take a united stance against Russia’s invasion of a sovereign nation. Until Russia pulls its forces out of the Donbas and no longer occupies Crimea, the sanctions should stay in place. If the West wants to go beyond making a symbolic statement, and to have any hope of changing Russia’s behavior, it should contemplate wielding policy tools it has not yet used, including a ban on the purchase of Russian oil and gas and a freeze on the assets of state-controlled banks and companies.

1 Victoria Nuland, Testimony to the Senate Foreign Relations Committee Hearing: “Russian Violations of Borders, Treaties, and Human Rights,” June 7, 2016, http://www.foreign.senate.gov/imo/media/doc/060716_Nuland_Testimony.pdf.

2 Victoria Nuland, “Testimony to the Senate Foreign Relations Committee Hearing,” 3.

WHY AND HOW WAS RUSSIA SANCTIONED?

On February 22, 2014, then Ukrainian President Viktor Yanukovich fled Ukraine amidst mass popular protests. Taking advantage of the political upheaval, Putin ordered the implementation of a plan for the annexation of Ukraine's Crimean Peninsula which began with the deployment of special forces.³ Working from its Black Sea Fleet base in Sevastopol, the Russian military gained control over the peninsula within ninety-six hours.⁴

On February 27, 2014, the parliament of Crimea was occupied by so-called "little green men," troops in Russian uniforms without insignia. Under their guns, parliament established a new pro-Russian government and instituted a so-called independence referendum in Crimea that later was reformulated into a referendum to join the Russian Federation. On March 1, 2014, the Federation Council, the upper chamber of Russia's parliament, approved the deployment of troops to Ukraine. On March 16, 2014, a so-called "referendum" in Crimea took place through which Russia justified the incorporation of the territory into the Russian Federation.

Western leaders started to worry after the decision of the Russian parliament to deploy military troops in Ukraine, and wanting to demonstrate that "Russia's actions have consequences,"⁵ both the United States and the EU agreed to use sanctions as an instrument of their foreign policy.⁶ Western sanctions against Russia were rolled out gradually, with the initial round targeting individuals, companies, and banks. The list of those sanctioned has been extended several times

and currently includes 128 people and 102 entities in the United States⁷ and 151 people and 37 companies in the EU.⁸

On March 5, 2014, the European Union announced its first Ukraine-related sanctions, visa bans, and asset freezes on eighteen individuals accused of undermining democracy, misappropriating Ukrainian property, and violating human rights.⁹ The next day, US President Barack Obama followed suit, ordering visa bans and asset freezes for those the administration determined to have "asserted governmental authority in the Crimean region without the authorization of the government of Ukraine,"¹⁰ thereby threatening "its peace, security, stability, sovereignty, and territorial integrity."¹¹ On March 16-17, 2014, the United States and the EU announced their new sanctions on Russian politicians and individuals, as well as related companies.¹² A similar decision was adopted by the EU Council.¹³ On March 20, Obama signed an executive order extending sanctions to companies in the financial services, energy, metals and mining, engineering, and defense and related industries, though the list of affected enterprises was released only in mid-July.¹⁴ Then on April 28, the United States expanded existing restrictions on the export of defense-related technologies and services to Russia.

3 *Crimea. Road to the Motherland*, Documentary film directed by Andrey Kondrashov, Russia: TV Channel Russia, March 15, 2015.

4 Sergey Safronov, "Admiral Kasatonov: Sevastopol preparing a military base in 'Mistral'," *Rossiya Segodnya*, last modified on March 03, 2015, <https://ria.ru/interview/20150313/1052368767.html>; Yuriy Butusov, "Who and how annexed Crimea," *Face News*, last modified on March 17, 2016, <https://www.facenews.ua/columns/2016/304820/>; "Control over Sevastopol Airport," *Argumenty i Fakty*, last modified on February 10, 2014, <http://www.aif.ru/euromaidan/uanews/1115467>.

5 "Remarks: by NATO Secretary General, Anders Fogh Rasmussen at the press conference held following the meeting of the NATO-Russia Council at NATP HQ, Brussels," *North Atlantic Treaty Organization*, last modified on March 5, 2014, http://www.nato.int/cps/en/natolive/opinions_107743.htm.

6 None of sanctions imposed by Western countries targeted Russia as a country but companies, banks and individuals. For ease of reading, "Russian sanctions" or "sanctions against Russia" will be used here.

7 "Sanctions list search," *Office of Foreign Assets Control*, last modified on October 4, 2016, <https://sanctionssearch.ofac.treas.gov/>.

8 "EU restrictive measure in response to the crisis in Ukraine," European Council: Council of the European Union, last modified on September 15, 2016, <http://www.consilium.europa.eu/en/policies/sanctions/ukraine-crisis>.

9 "Council Decision 2014/119/CFSP," *Official Journal of the European Union* 119 (2014), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2014:066:0026:0030:EN:PDF>.

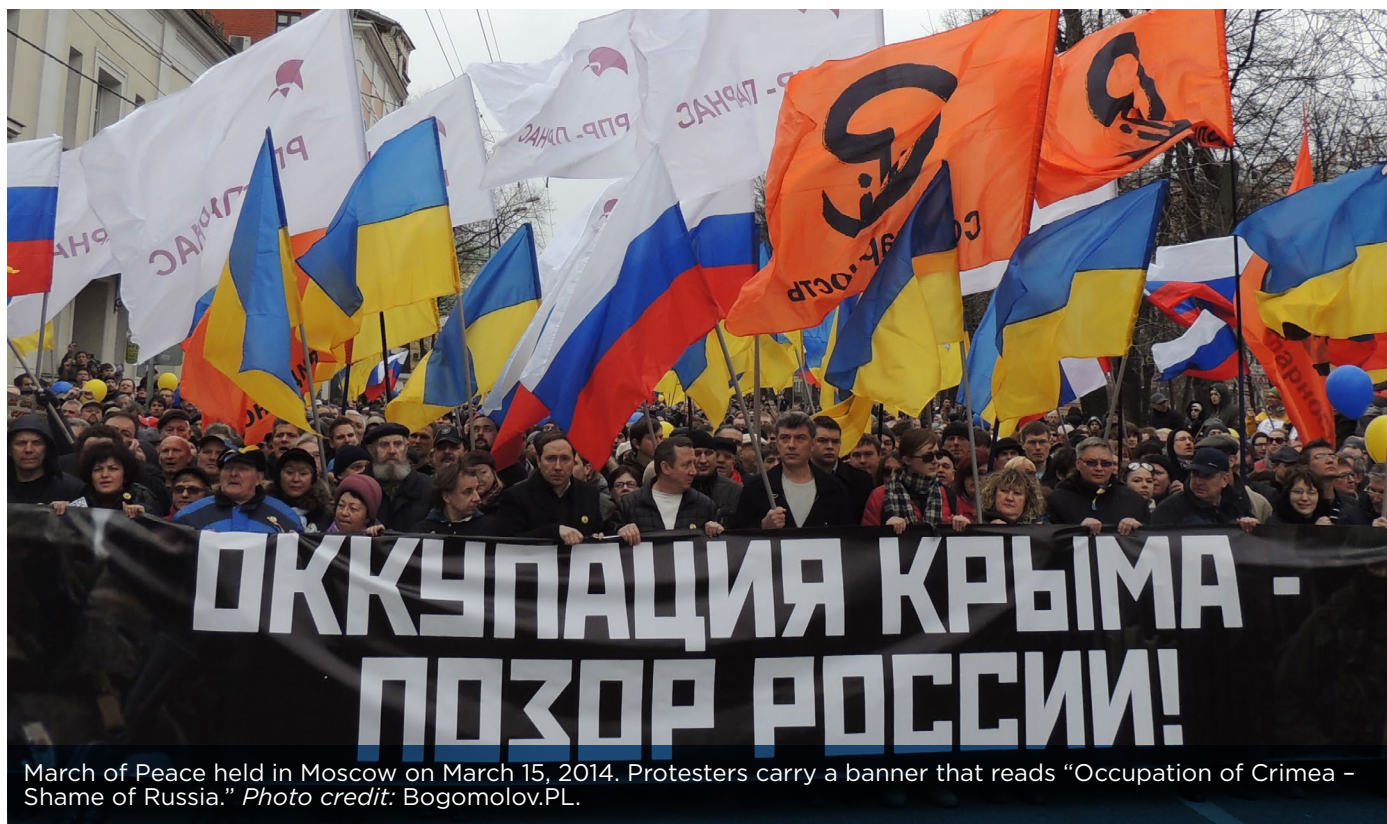
10 "Executive Order 13660," *Federal Register* 46 (2014): 79, https://www.treasury.gov/resource-center/sanctions/Programs/Documents/ukraine_eo.pdf.

11 "Executive Order 13660," *Federal Register* 46 (2014).

12 "Executive Order 13661," *Federal Register* 53 (2014): 79, https://www.treasury.gov/resource-center/sanctions/Programs/Documents/ukraine_eo2.pdf.

13 "Council Decision 2014/145/CFSP," *Official Journal of the European Union* 145 (2014), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2014:078:0016:0021:EN:PDF>.

14 "Executive Order 13662," *Federal Register* 56 (2014): 79, https://www.treasury.gov/resource-center/sanctions/Programs/Documents/ukraine_eo3.pdf.



March of Peace held in Moscow on March 15, 2014. Protesters carry a banner that reads "Occupation of Crimea - Shame of Russia." Photo credit: Bogomolov,PL.

The sanctions of March and April 2014 were particularly narrow, aiming to put pressure on Russian and Crimean politicians as well as some of Putin's cronies and their businesses. Instead of applying to all ninety members of the Russian Federation Council, the upper chamber of the parliament, who granted Putin permission to deploy troops in Ukraine,¹⁵ only nine members were included in the US Specially Designated Nationals (SDN) list.¹⁶ In addition, the sanctions did not extend to relatives of those on the lists, effectively allowing those targeted to circumvent the asset freeze. In all, the sanctions regime did not take into account potential legal maneuvering by sanctioned individuals.¹⁷

15 Anton Klyuchkin and Denis Dmitriev, "Some failure in the electronic registration of votes, right?" *Lenta*, last modified March 13, 2014, <https://lenta.ru/articles/2014/03/13/sovnet/>.

16 Valentina Matvienko, Evgheny Bushmin, Andrey Klisshas, Vladimir Dzhabarov, Viktor Ozerov, Nikolai Ryzhkov, Alexander Tootonov, Oleg Panteleev, and Sergey Tsekov.

17 For example, one of Putin's closest associates Gennady Timchenko got "a lucky chance" to sell his holding in Gunvor oil trading company one day before the sanctions were imposed. Another of Putin's cronies, Arkady Rotenberg, sold his stakes in "Gazprom Burenie" and "Mostotrest," as well as in some development projects to his son Igor in October 2014. (Anya Sotnikova and Sergey Kanashevich, "Arkadiy Rotenberg sold 'Gazprom Burenie' to his son," *RBK News*, last modified on October 30, 2014, <http://www.rbc.ru/business/30/10/2014/5451fe1bcbb20f3bfdc60edb>). Other Putin friends have reduced their stakes in several companies by hiding their holdings on the balance sheets of

Meanwhile, in mid-April, three weeks after the annexation of Crimea, Russian-speaking units of armed personnel, wearing uniforms without insignia, began trying to foment revolts in many eastern and southern Ukrainian cities. In most regions, their efforts met with little support, but in the Donbas, the Russian-supported forces established strongholds in Luhansk and Donetsk and from there began to move west. The Ukrainian counter-offensive, which began in June 2014, was making steady gains and by late July was on the verge of suppressing the revolt when Moscow deployed regular troops with heavy weapons in parts of the Donetsk and Luhansk regions and supported the establishment of the self-proclaimed Donetsk and Luhansk people's republics. Those two territories comprise seventeen thousand square

state-controlled entities (e.g., after sanctions were imposed, Gazprom announced its takeover of Gazprombank. Previously, the bank was controlled by Putin associate Yuri Kovalchuk). Also, other Russian oligarchs loyal to Putin have benefitted (e.g., Surgutneftegaz and Severstal's owner Alexey Mordashov who is a shareholder in National Media Group and Video International, which are companies de facto controlled by Kovalchuk); Roger Boyes, and Katerina Kravtsova, "Oligarchs beat sanctions by giving assets to family," *The Times*, last modified on July 22, 2015, <http://www.thetimes.co.uk/tto/news/world/europe/article4504478.ece>; "Putin confidant comes as a false sick in EU," *Bild*, last modified on June 21, 2015, <http://www.bild.de/politik/ausland/wladimir-putin/vertrauter-spielt-krank-41441360.bild.html>.

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kilometers, approximately equal to the area of Slovenia or Montenegro, and they have not been recognized by any country, including Russia.

On June 23, 2014, following the massive involvement of Russian troops and weapons in eastern Ukraine, the EU imposed a ban on imports from Crimea or Sevastopol¹⁸ and initiated a new wave of sanctions, which have been much more painful for the Russian economy.

On July 16, the US imposed its first round of sectoral sanctions against Russia—financial sanctions¹⁹ on two banks and two energy companies.²⁰ To effectuate this major step, the Treasury Department created a whole new sanctions list, the Sectoral Sanctions Identification (SSI) List.

On July 17, the downing of Malaysia Airlines flight MH-17 by a Russian BUK missile changed the political mood in Europe dramatically, and less than two weeks later, the EU introduced sectoral sanctions similar to those imposed by the United States.

These sanctions may be divided into three groups:

1. Financial sanctions: 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 a ban on loans with maturity periods exceeding thirty days for some of Russia's biggest, predominantly state-controlled, banks and companies.

2. Sanctions on defense industries: two-way arms embargo and a ban on exports of items with both civilian and military uses.
3. Sanctions on the energy sector: ban on exporting equipment and providing specific services for Arctic or deep-water oil exploration or production, and for shale oil exploration.²¹

In December, the EU extended its Crimea sanctions by banning investment or real estate purchases on the peninsula, as well as prohibiting the provision of services to various sectors. Similar sanctions were introduced by the United States.

Some other countries, including Japan, Canada, Switzerland, Norway, Australia, and New Zealand, have applied sanctions, while emerging economies have not followed suit. Though the United States and the EU have coordinated their sanctions, their lists are not identical and there are some noteworthy differences.²²

Since December 2014, the sectoral sanctions have been fine-tuned, but not expanded. The size of Russia's economy probably saved it from deeper sanctions, such as those imposed, at various points, on South Africa, Iran, Libya, or North Korea, with the West proceeding cautiously to protect its own economic interests.

In the EU, sanctions come up for renewal every six months. The schedule of events and decisions of the United States and the EU on sanctions together with classification of sanctions is shown in appendix 1.

18 "Council decision 2014/386/CFSP," *Official Journal of the European Union* 386 (2014), <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:percent3A32014D0386>.

19 "Executive Order 13662," *Federal Register* 56 (2014): 79, https://www.treasury.gov/resource-center/sanctions/Programs/Documents/ukraine_eo3.pdf.

20 The following transactions by US persons or within the United States were prohibited: transacting in, providing financing for, or otherwise dealing in, new debt of longer than ninety days maturity (reduced to 30 days on September 12, 2014) or new equity for these persons, their property, or their interests in property (Directives 1-3 under the Executive Order #13662).

21 Five Russian energy companies were included into the US SSI list on September 12, 2014 while the EU by its Council Regulation No 960/2014 prohibited all deep-water exploration and production projects in Russia (Directive 4 under the Executive Order #13662).

22 E.g., prominent persons such as former Chief of the Presidential Administration Sergei Ivanov and two of Putin's cronies (Boris Rotenberg and Gennady Timchenko) are included in the US SDN list but are not under the EU sanctions.

WERE THERE OTHER OPTIONS?

Other than sanctions, the West used isolation as a lever against Russia. The country was excluded from the Group of Eight (G8), which canceled a summit planned for Russia.²³ All types of dialogue with NATO, the EU, and the United States were suspended, as were military exchanges and joint exercises. NATO organized a special meeting to discuss security concerns raised by Poland and canceled its first joint mission with Russia on neutralizing Syria's chemical weapons.²⁴ Negotiations on Russia's Organization of Economic Co-operation and Development (OECD) accession were also frozen.²⁵

Because of its vastness, and with its involvement in various international forums, Russia cannot be completely isolated, nor did the West's effort get much buy-in from major emerging economies, such as China, India, Brazil, and Israel.²⁶

Russia participated in the Group of Twenty (G20) meeting in November 2014 in Brisbane despite attempts by the host country to keep it out;²⁷ that same month, China never even raised the issue of Ukraine when it hosted the Asia-Pacific Economic Cooperation (APEC)-2014 meeting. Russia became an active player in the Iran nuclear talks as well as in the international dialogue on North Korea, and it remained co-chair of the International Syria Support Group and co-led the Vienna peace talks.

Russian aggression against Ukraine left the West with few options. Short of a direct military attack on Russia, the West could have, for instance, deployed military police in the very early stage of unrest in eastern Ukraine or supplied weapons to the Ukrainian army starting in July 2014, after the Russian army started its military actions in Donbas.²⁸ It did neither.

23 "G7 countries suspend planning for Russia Summit," *Radio Free Europe/Radio Liberty*, last modified on March 3, 2014, <http://www.rferl.org/content/ukraine-will-call-up-military-reservists/25282304.html>.

24 "Remarks: by NATO Secretary General, Anders Fogh Rasmussen at the press conference held following the meeting of the NATO-Russia Council at NATP HQ, Brussels," North Atlantic Treaty Organization, last modified on March 5, 2014, http://www.nato.int/cps/en/natolive/opinions_107743.htm.

25 "Statement to the media by NATO Secretary General Anders Fogh Rasmussen following the meeting of the North Atlantic Council," North Atlantic Treaty Organization, last modified on March 4, 2014, http://www.nato.int/cps/en/natolive/opinions_107722.htm.

26 E.g., "In terms of economic pressure, the Chinese have not generally moved to the types of sanctions that we have with the Europeans"—"Briefing by Deputy National Security Advisor

for Strategic Communications Ben Rhodes," The White House: Office of the Press Secretary, last modified on March 24, 2014, <https://www.whitehouse.gov/the-press-office/2014/03/24/briefing-deputy-national-security-advisor-strategic-communications-ben-r>.

27 Mike Callaghan, "Banning Putin from the G20 isn't that simple," *ABC News*, last modified on July 21, 2014, <http://www.abc.net.au/news/2014-07-21/callaghan-banning-putin-from-the-g20-isnt-that-simple/5612438>.

28 In practice, various Western countries have delivered some non-lethal military equipment and offered some training but, it has been little and with delay.

ARE SANCTIONS WORKING?

The sanctions introduced against Russia had three goals: to force the Kremlin to change its course in Ukraine,²⁹ “to continually raise the costs for Russia of their actions” in Ukraine,³⁰ and to demonstrate a common Western approach to Russia’s military actions.

Their effect on Russia’s foreign policy and economy merits a deeper analysis, but before that, a few quick words about the Crimea-related and personal sanctions, and about the West’s response to Russia.

The success of the Crimea sanctions has been mixed. On the one hand, they have stunted Crimea’s economic growth under Russian occupation and have prevented some firms from operating there. Tourism, one of Crimea’s largest industries before the annexation, lost 15–20 percent of visitors and has not rebounded. Many industrial and agricultural companies were affected by cancellation of water and electricity supply from Ukraine. As a result, Crimea became a greater economic burden to Russia. On the other hand, the Russian government has sought avenues for circumventing the sanctions and to prop up the Crimean economy by investing in infrastructure, defense, and military sectors.

No Western country has recognized Crimea’s annexation, and it legally remains an occupied territory of Ukraine.³¹ However, Russia has swiftly moved to

integrate the peninsula, introducing Russian law, replacing the Ukrainian hryvnia with the ruble, and pouring billions of dollars into higher wages and pensions, social services, and industrial infrastructure.

Further, while many Russian state companies are reluctant to work on the peninsula lest they fall into the sanctions net, Russia props up defense companies in Sevastopol with military orders and boosts employment with stepped-up infrastructure construction. Western sanctions hinder the activity of big Russian banks in Crimea but fifteen small- and medium-sized Russian banks run their business operations there, while only five of them are included on the US sanctions list. The Russian government has also established methods and institutions to ensure that banking and credit transactions conducted in Crimea are registered in Russia and therefore are not blocked by Western sanctions.³²

As for the asset freezes and visa bans, their limited nature means that they have likely had little impact on Russian policy towards Ukraine. In the long term, the sanctioned individuals will leave active political and business life or will find ways to circumvent the sanctions. This means that new sanctions on new individuals may have to be continuously updated and enacted.

On the last point, with the imposition of sanctions and the suspension of Russia from various multilateral forums, it is notable, if not remarkable, that the West has been able to take a united stance against Russian aggression despite the EU’s complicated decision-making process and the vast business interests of many European companies in Russia.

29 “Statement by the President on new sanctions related to Russia,” The White House: Office of the Press Secretary, last modified on September 11, 2014, <https://www.whitehouse.gov/the-press-office/2014/09/11/statement-president-new-sanctions-related-russia>.

30 “Press conference with President Obama and President Park of the Republic of Korea,” The White House: Office of the Press Secretary, last modified on April 25, 2014, <https://www.whitehouse.gov/the-press-office/2014/04/25/press-conference-president-obama-and-president-park-republic-korea>; “Statement by the President of the European Council Herman Van Rompuy and the President of the European Commission in the name of the European Union on the agreed additional restrictive measures against Russia,” *European Council Press*, July 29, 2014, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/144158.pdf.

31 Six countries only have recognized the annexation of Crimea: Cuba, Nicaragua, Venezuela, Syria, Afghanistan, and North

Korea. Jeremy Bender, “These are the 6 countries onboard with Russia’s illegal annexation of Crimea,” *Business Insider*, last modified on June 1, 2016, <http://www.businessinsider.my/six-countries-okay-with-russias-annexation-of-crimea-2016-5/#dhrDYd2zXEsacQwP.99>.

32 Anna Eremina, “Tsentrobank expects the availability of Visa cards by 2016,” *Vedomosti*, last modified on November 13, 2015, <https://www.vedomosti.ru/finance/articles/2015/11/13/616687-krimu-visa>.

HAVE SANCTIONS INFLUENCED RUSSIA'S FOREIGN POLICY?

The biggest debate among politicians and experts concerns whether sanctions have been able to stop Russian aggression and more broadly to affect Russia's policy in Ukraine. The hard truth is that Russia has achieved its goals in Crimea and created a hotbed of tension in the east of Ukraine, allowing the Kremlin to destabilize its neighbor at any time. Meanwhile, the West has been unable to compel Moscow to fulfill the Minsk ceasefire agreements or even to acknowledge its direct participation in the conflict.

Western conventional wisdom says that the July 2014 wave of sanctions, restricting the ability of Russian banks and companies to do business in the West, stopped Russia from escalating the conflict into a large-scale military operation and from occupying a significant part of Ukrainian territory (e.g., carving out a land corridor to Crimea along the Black Sea).³³ While it may be true that sanctions, combined with Russian military casualties, had limited Putin's plans for the use of military force in Ukraine.

Yet, it is a war nonetheless. Over the last two years—and since the signing of Minsk-1—Moscow has taken more than 500 square kilometers of additional Ukrainian territory in small increments.³⁴ In February 2015—and after the signing of Minsk-2—separatists supported by the Russian military captured a logistically important city, Debaltseve, in a major battle. Static sanctions have not prevented this type of “nibbling away,” and the West has been reluctant to add additional sanctions for Russia's constant incursions.

Likewise, the West has not publicly reacted to the other forms of hybrid warfare that Russia wages against Ukraine, mostly in the economy and trade. Russia terminated a free-trade agreement with Ukraine and imposed tariffs and other restrictions on imports of Ukrainian goods.³⁵ Since July 1, 2016, Russia has *de facto* banned the transit of Ukrainian goods through its territory to Central Asia,³⁶ by forcing them to enter Russia via Belarus. Russia also banned the supply of diesel fuel to Ukraine in September 2016.³⁷

Static sanctions have not prevented this type of “nibbling away” [of Ukrainian territory], and the West has been reluctant to add additional sanctions for Russia's constant incursions.

THE MINSK STALEMATE

Economic sanctions have been linked to the Minsk-2 agreement since shortly after it was signed in February 2015. Until all of its points are implemented, including Ukraine's control over its own eastern border, the United States and EU have agreed they will stay in force.

With negotiations in deadlock in 2016, that day seems far off. Minsk-2 drafts the road map for a political solution to the conflict, starting with a ceasefire, moving on to the legal recognition by Ukraine of a special status for Donbas including special electoral regulation, and ending with the transfer of control over the

33 But this view does not take into account the necessity for Russia to deploy a huge occupational army in order to keep control over it—the size of the land corridor to Crimea along the Black Sea could be three times bigger than the occupied territory of Donbas.

34 “Militants after agreements in Minsk seized 500 square km,” *Liga News*, last modified on December 20, 2015, http://news.liga.net/news/politics/4835620mid_boeviki_posle_soglasheniy_v_minske_zakhvatili_500_kv_km_.htm.

35 “Ukraine released a statement on the WTO discriminatory trade restrictions by the Russian Federation,” Ministry of Economic Development and Trade of Ukraine, last modified on January 15, 2016, <http://www.me.gov.ua/News/Detail?lang=uk-UA&id=9abb5231-74f1-472d-a747-8133d94eb74a&title=UkrainaOpriliudnilaVSotZaiavuSchodoDiskriminatsiiniikhTorgovelnikhObmezhenZBokuRosiiskoiFederatsii>; “Russian Federation placed embargo on Ukrainian dairy products,” *Regnum Informational Agency*, last modified on February 5, 2007, <https://regnum.ru/news/polit/777203.html>.

36 “Law from President of the Russian Federation effective from January 1, 2016 to ensure economic security and national interests in relation to transit of goods out of Ukraine to the Republic of Kazakhstan through Russian territory,” Official Internet Portal for Legal Information, last modified on July 3, 2016, <http://publication.pravo.gov.ru/Document/View/0001201607030001>.

37 “‘Transneft’ will stop its supply of diesel to Ukraine,” *Interfax*, last modified on September 9, 2016, <http://www.interfax.ru/business/527528>.



Separatist forces of the war in Donbas with Russian military equipment in July 2015. *Photo credit:* Gennadiy Dubovoy/Wikipedia.

Ukrainian state border to Kyiv. Kyiv has held up much of its end of the deal—the special status of Donbas became law in March 2015—but refuses to announce elections in Donbas, claiming that the ceasefire is not fully implemented, that Russia continues to supply weapons to the region and keeps its military presence there, and that elections in Donbas should be conducted based on European standards.³⁸

Although Russia signed Minsk-2, it rejects any responsibility for its implementation, insisting that negotiations should be between Kyiv and separatists while still demanding that elections in Donbas be a prerequisite for any further actions.

This could go on for a while, as Russia has paid a relatively modest price for its meddling in Ukraine's east: experts estimate that the current cost of

maintaining the separatists' regime is \$1 billion to \$1.5 billion per year,³⁹ which amounts to 0.35–0.5 percent of the annual expenditures of the Russian federal budget, while the toughest part of Western sanctions has already taken its toll. Therefore, Russia seems willing to bear the costs of sanctions in the medium term with the hope that eventually the West will splinter or lose its resolve. Given that static sanctions have not persuaded Moscow to implement Minsk-2, additional serious sanctions for ongoing violations would be a better policy response and a better measure of how or if sanctions influence Russian foreign policy.

³⁸ I.e., Ukrainian political parties should be able to participate in elections, all Ukrainian citizens relocated from Donbas should be able to vote, international monitoring should be established, and Ukrainian mass-media should be able to cover elections.

³⁹ Michael Sokolov, "Andrey Nechaev: 'Inside Putin has already given up Donbas and Assad,'" *Radio Liberty*, last modified on January 29, 2016, <http://www.svoboda.org/a/27518717.html>; Dimitriy Pisarev, "How much does it cost for Russia Federation Donbas' occupation," *Strana*, last modified on December 21, 2016, <http://strana.in.ua/news/resonance/31708-skolko-stoit-dlya-rf-okkupaciya-donbassa.html>; Boris Nemtsov, "Putin. War," *Itogi*, last modified on January 31, 2015, <http://www.putin-itogi.ru/putin-voina/>.

HAVE SANCTIONS HURT THE RUSSIAN ECONOMY?

“Russia is isolated with its economy in tatters,” Obama proclaimed in his January 2015 State of the Union address, assessing the results of a US policy of sanctions and containment.⁴⁰ At the time, many believed the same thing. Russia’s currency was in free fall, its budget revenues declining, its government spending reserves it had taken years to accumulate. Some experts even predicted the collapse of the Russian economy.⁴¹

Although Russia plunged into a crisis that would last for six consecutive quarters, the real scale of economic shock was less significant.⁴² GDP fell by 3.7 percent in 2015, and most experts project a 0.6-0.8 percent drop in 2016.⁴³ Recovering oil prices have allowed the ruble to stabilize, and a 15 percent fall in private consumption has not led to any visible increase in social tension nor has it weakened support for Putin or his aggressive foreign policy.

In August 2015, the International Monetary Fund (IMF) reported that sanctions had cost the Russian economy 1-1.5 percent of GDP in that year and that their effect would diminish going forward.⁴⁴ Russian experts⁴⁵

put the cost at 0.5-1 percent of GDP per year, with financial sanctions responsible for most of that. This is a serious impact, but by itself, it has not persuaded Putin to change his policy in Ukraine even as he and his surrogates lobby hard for Europeans to lift the sanctions.

Right from the start, the effectiveness of sanctions was never assured. In announcing the second wave on April 28, 2014, Obama acknowledged that “we don’t yet know whether it’s going to work.” He said the goal was to “change [Putin’s] calculus with respect to how the current actions that he’s engaging in could have an adverse impact on the Russian economy over the long haul.”⁴⁶

Even as the United States and EU introduced more severe financial and sectoral sanctions from July through September 2014, they stayed away from the most painful sanctions used against Iran and Libya, a boycott of the country’s hydrocarbons and a freeze on all of its foreign assets, including those of the central bank. The outcome was predictable: Western sanctions have had some effect, but it was much less than the impact of collapsing oil prices.

FINANCIAL SANCTIONS AND THE RUBLE’S COLLAPSE

The impact of financial sanctions, prohibiting Western banks and companies from providing capital and loans to certain Russian banks and companies, is the easiest to measure. Though they cover very few (mainly state-owned) banks and companies, these sanctions have become de facto comprehensive. Few Russian banks and companies were able to raise capital within the last two years, and in May 2016, the Russian government itself was unable to place its Eurobonds in Western markets, as both European and American banks declined to participate in the placement.

Since 2005, the Russian economy has relied heavily on foreign borrowing. In autumn 2014, many Russian banks and companies were shut out of refinancing by sanctions and were forced to repay old loans. Consequently, the volume of foreign-loan repayments

40 “Remarks by the President in State of the Union Address,” The White House: Office of the Press Secretary, last modified on January 20, 2015, <https://www.whitehouse.gov/the-press-office/2015/01/20/remarks-president-state-union-address-january-20-2015>.

41 Anders Aslund, “Russia’s output will slump sharply in 2015,” *American Interest*, last modified on January 15, 2015, <http://www.the-american-interest.com/2015/01/15/russias-output-will-s slump-sharply-in-2015/>.

42 Assessing the economic impact of Western sanctions on the Russian economy is difficult, because Russia is facing a structural economic crisis that was caused by falling oil prices and domestic institutional weaknesses resulting in decline in investment and Western sanctions. As all those factors act together, it is not a trivial task to separate their effects.

43 “Minecon foresees 0.1-0.3 percent growth in Q1,” *Vesti*, November 11, 2016, <http://www.vestifinance.ru/articles/77496>; IMF and the World Bank, *World Economic Outlook Update*, October 2016, <http://www.imf.org/external/pubs/ft/weo/2016/02/pdf/c1.pdf>; The World Bank, *Russia Economic Report*, November 2016, <http://documents.worldbank.org/curated/en/424231478762595715/pdf/110037-WP-P161778-PUBLIC-ENGLISH-NovfinalRussialnching%20towardsGrowthRERfinal.pdf>.

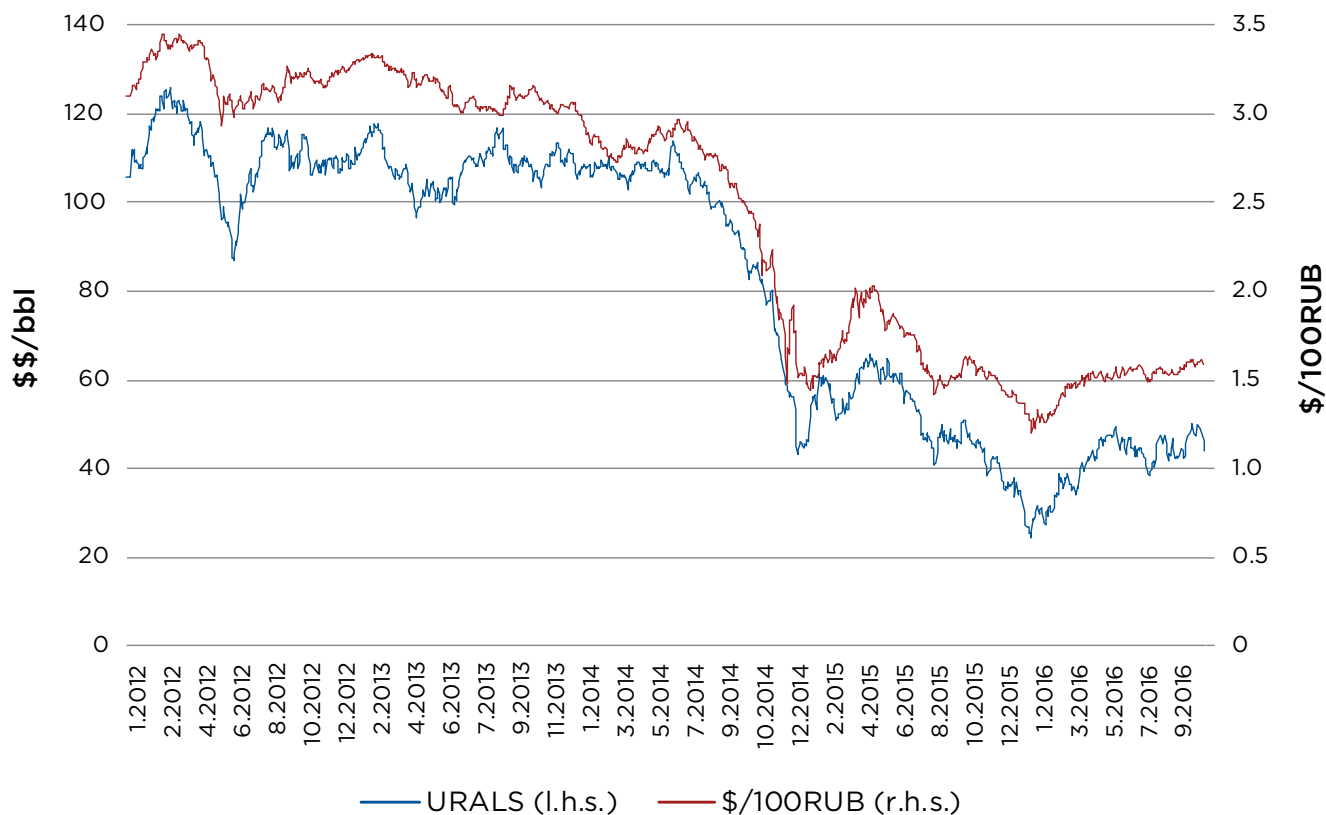
44 International Monetary Fund, “Russian Federation: 2015 article IV consultation—press release; and staff report,” Report No. 15/211, last modified on August 2015, <http://www.imf.org/external/pubs/ft/scr/2015/cr15211.pdf>.

45 Olga Kuvshinova, “Russian economy experienced loss in growth by 8.4 percent,” *Vedomosti*, last modified on February 5, 2016, <https://www.vedomosti.ru/economics/articles/2016/02/05/626922-ekonomika-lishilas>.

46 “President Obama says new sanctions will target Russia defense sector over moves in Ukraine,” *CBSNews*, last modified on April 28, 2014, <http://www.cbsnews.com/news/president-obama-new-sanctions-target-russia-defense-sector-over-ukraine/>.

EVALUATING WESTERN SANCTIONS ON RUSSIA

Figure 1. Urals oil price (\$/barrel)* and Russian Ruble exchange rate (\$/RUB100), 2012-16



Source: Central Bank of Russia, Reuters.

* Urals oil refers to the oil brand used as the basis for pricing of the Russian export oil mixture.

in late 2014 to early 2015 was enormous. According to the Bank of Russia, the quarterly debt repayment in this period amounted to approximately 10 percent of GDP.⁴⁷ Those repayments, along with declining oil prices and financial sanctions, destabilized Russia's foreign exchange market in November and December 2014 (see figure 1). Banks and companies that wanted to repay their loans were looking for hard currency, just as export proceeds were declining because of the fall in oil prices. The ruble devalued fast—some days losing up to 10 percent of its value.

The situation was exacerbated by mistakes made by the monetary authorities. Beginning in June 2013, the Central Bank of Russia (CBR) underestimated the changes in the current account and intervened regularly in the domestic market by selling foreign currency—from June 1, 2013, until September 1, 2014, the CBR sold \$100 billion or 20 percent of its foreign currency reserves. That policy fed demand for imported goods and services, thus setting up the ruble for a major devaluation, which happened when the Central Bank stopped currency interventions.

In early November 2014, the CBR announced it would let the ruble float freely—not the best time, as oil prices had been falling rapidly—for two months—but continued to sell foreign currency, losing its credibility. At the same time, the CBR de facto bet *against* the ruble—it provided extensive ruble loans to Russian banks at 10 percent annual rate, while banks used these funds to purchase foreign currencies, thus gaining 10 percent in dollars in one week because of devaluation.⁴⁸

All combined: falling oil prices, debt repayment pressures, policy mistakes, and lack of access to foreign credit markets created a perfect storm for the Russian financial market in mid-December 2014, resulting in the collapse of the ruble, which lost 50 percent of its value from the beginning of the year.

47 "Statistics of the Internal Sector," Central Bank of the Russian Federation, 2016, <http://cbr.ru/statistics/?Prtid=svs>.

48 According to CBR data ("Databases," Central Bank of the Russian Federation, http://cbr.ru/hd_base/Default.aspx?Prtid=repo_debt, http://cbr.ru/hd_base/Default.aspx?Prtid=dv) from October 2 until December 22, 2015 the Central Bank provided to banks 3.3 trillion rubles in loans (\$80 billion at the average November exchange rate) and sold them more than \$40 billion. ("Data on the Bank of Russia FX operations," Central Bank of the Russian Federation, http://www.cbr.ru/hd_base/Default.aspx?Prtid=valint_day).

Table 1. Comparison of the Pressure of Oil Prices and Western Sanctions on the Russian Balance of Payments, \$billion/quarter

	Q4/14	Q1/15	Q2/15	Q3/15	Q4/15	Q1/16	Q2/16	Q3/16
Repayment of foreign loans	35.2	38.1	11.2	6.3	14.2	9.3	-2.8	7.2
Decline in revenues from hydrocarbons export	16.5	32.2	40.5	41.4	42.3	54.8	50.3	48.3

Source: Central Bank of Russia.

This created the impression that the entire economy was collapsing.

However, after December 16, when the CBR conventionalized its policy (increased the interest rate, stopped refinancing the banking system in rubles, and started to provide dollar-denominated loans to exporting companies for debt-repayment),⁴⁹ the situation started to improve. Banks raised their ruble deposit rates from 8–9 percent in October–November 2014 to 15–16 percent in January 2015,⁵⁰ and households once again put their money in their bank accounts.⁵¹ In the beginning of February 2015, oil prices rebounded and by May, the ruble had regained 40 percent of its value.

Meanwhile, since the second quarter of 2015, the debt repayment schedule has eased, along with the pressure on Russia’s balance of payments, thus diluting the impact of the financial sanctions. Table 1 demonstrates that since the end of 2014, the relative pressure of declining oil prices on the Russian balance of payments grew steadily, while that of Western financial sanctions (foreign debt repayment) declined. After the first quarter of 2015, the debt repayment fell to slightly more than \$10 billion per quarter on average in the following four quarters. At the same time, losses in export earnings due to declining oil prices rose from \$16.5 billion in the last quarter of 2014 to more than \$40 billion per quarter in mid- to late-2015, and up to \$55 billion in the first quarter of this year (all of those

compared to the average of seven previous quarters, Q1/2013–Q3/2014).

Overall, this suggests that the storm on the Russian financial market in late 2014–early 2015 was caused by a set of factors in which sanctions played an important but not decisive role. Moreover, with time, the impact of Western financial sanctions has declined significantly and in their current form they will never be felt as keenly as they were in late 2014.

According to the CBR projections, in the next two years the repayment of foreign corporate debt will not exceed \$20 billion per quarter.⁵² Usually, the permanent repayment of foreign debt creates pressure on the economy, forcing the government to reduce domestic consumption and investment, thus slowing economic growth. In Russia, however, this pressure is alleviated by the decline in capital outflow: ironically, many business people and wealthy families, frightened by the possible extension of financial sanctions and the freezing of all Russian assets abroad, have decided to keep their assets inside the country.⁵³ And, in September 2016, the Russian Federation and many Russian companies, which are not under sanctions, maneuvered to gain access to Western financial markets and have been able to raise capital from Western investors.⁵⁴

49 Central Bank of the Russian Federation, “Press of the Russian Central Bank,” last modified on December 16, 2014, http://cbr.ru/press/PR.aspx?file=16122014_004533dkp2014-12-16T00_39_23.htm.

50 Central Bank of the Russian Federation, “Interest rates and structure of loans and deposits by maturity,” http://cbr.ru/statistics/?PrtlId=int_rat.

51 Central Bank of the Russian Federation, “Statistics on bank deposits and other funds of legal entities and individuals in rubles, foreign currency and precious metals,” November 11, 2016, http://cbr.ru/statistics/UDStat.aspx?TbllD=302-21&pid=sors&sid=ITM_30761.

52 “External sector statistics,” Central Bank of the Russian Federation, last accessed on November 28, 2016, <http://cbr.ru/statistics/?PrtlId=svs>.

53 In the second quarter of 2016, the net inflow of capital to the corporate sector was recorded—Russian companies received more capital from the rest of the world than they have repaid on old loans; Taras Fomchenkov, “Return of capital to Russia will support Russian ruble,” *Russian Gazette*, last modified on August 31, 2016, <https://rg.ru/2016/08/31/sem-nadezhd-rossijskogo-rublia.html>.

54 “More than half of Russian Eurobonds are bought by US investors,” *Gazeta*, September 23, 2016, https://www.gazeta.ru/business/news/2016/09/23/n_9143789.shtml; “Russian railway presented upcoming Eurobonds,” *Financial Cbonds Information*, last modified on September 21, 2016, <http://ru.cbonds.info/news/item/848073>; “Global ports published Eurobonds,” *SeaNews*, last modified on September 26, 2016, <http://www.seanews.ru/news/news.asp?newsID=1024281>.

EVALUATING WESTERN SANCTIONS ON RUSSIA

Sectoral Collapse

Energy: Crisis? What Crisis?

Western bans on exporting equipment and providing certain services to the Russian energy industry did not touch either power generation or the gas sector because of the EU's dependence on Russian gas imports. Though the United States has imposed financial sanctions on Gazprom, the Russian-state-owned gas giant that has been one of the main weapons in Russia's economic war against Ukraine in

the past decade, the EU has not joined in. Moreover, Gazprom has been able to raise capital in Europe.⁵⁵

As for the oil industry, sanctions prevent Western companies from providing technology or know-how for Arctic or deep-water oil exploration and

⁵⁵ Gazprom raised 1 billion Euros in October 2015 and 500 million Swiss francs in March 2016. "Bonds: Gazprom's Eurobonds issued under the Euro Medium Term Note Program," Gazprom, last accessed November 28, 2016, <http://www.gazprom.com/investors/creditor-relations/bonds/>.

Table 2: Russian energy projects affected by sanctions

<p>Kara Sea, East Prinovozemelskiy blocks 1, 2, and 3</p>	<p>Rosneft and ExxonMobil signed a Strategic Cooperation Agreement in 2011 and established a joint venture (JV), Rosneft (66.7 percent) and ExxonMobil (33.3 percent).</p> <p>Estimated resources, oil and gas:ⁱ block 1 (3.33 billion tons and 3.317 billion m³), block 2 (1.82 billion tons and 2.733 billion m³), block 3 (1.118 billion tons and 8.54 billion m³). In October 2014, the first well was drilled in the Pobeda (Victory) deposit that confirmed its resources (129 million tons and 392 billion m³).ⁱⁱ After finishing the drilling, ExxonMobil stopped further activity.</p>
<p>Black Sea, Tuapse Trough License block</p>	<p>Rosneft and ExxonMobil signed a Strategic Cooperation Agreement in 2011 and established a joint venture, Rosneft (66.7 percent) and ExxonMobil (33.3 percent). The block covers an area of 11,200 square km, with the sea depth varying from 1,000 to 2,000 meters. Exploration activities have revealed approximately seventy prospective structures within this ultra-deep block. Geological research is frozen.</p>
<p>Western Siberia, four licenses covering an area of 2,700 km² in Khanty-Mansi Autonomous District</p>	<p>In May 2014, LUKOIL and Total agreed to establish a JV (51 percent/49 percent) to explore and develop the tight oil potential of the Bazhenov play in Western Siberia. The JV should assess the technical feasibility of developing the tight oil potential of the Bazhenov formation initially on. Seismic acquisition should start in 2014 and exploration drilling to follow in 2015.ⁱⁱⁱ The project is frozen.</p>
<p>Okhotsk Sea, Sakhalin-3 project</p>	<p>Gazprom owns Yuzhno-Kirinskoe deposit with combined resources of oil and gas. In September 2015, the United States covered the oil part of this project by sanction regime.^{iv}</p>
<p>Western Siberia, Salym deposits</p>	<p>Since 2003, Gazpromneft and Royal Dutch Shell have operated Salym Petroleum development. In October 2014, Shell suspended work on this joint venture to develop shale oil.^v</p>
<p>Okhotsk Sea, Sakhalin-1 project</p>	<p>ExxonMobil keeps 30 percent in a production-sharing agreement project while Rosneft keeps 20 percent. The last stage of the project—Berkut platform—started to produce oil in January 2015. Exxon is not allowed to collect revenues from the facility.^{vi}</p>

ⁱ "Russia's Arctic seas," RosNeft, https://www.rosneft.com/business/Upstream/exploration/Prospective_projects/arctic_seas/.

ⁱⁱ Exxon announced success at drilling of the well 1-University in the Kara Sea," Interfax, last modified on October 31, 2014, <http://www.interfax.ru/business/405055>.

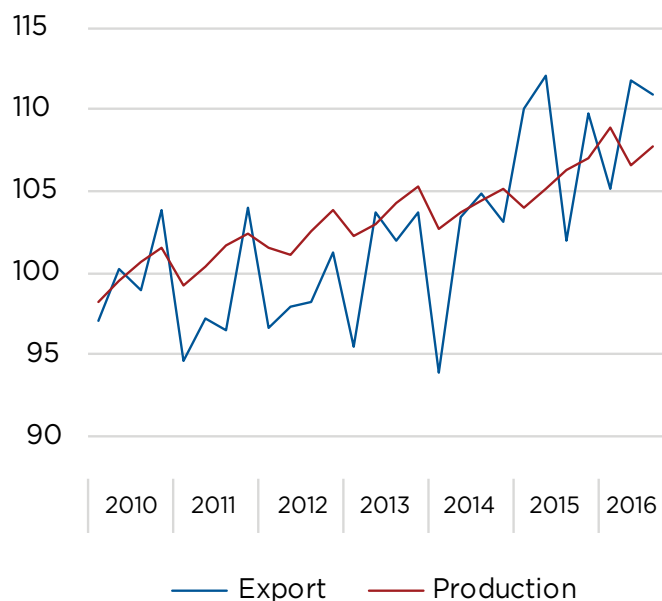
ⁱⁱⁱ "Russia: Total combines efforts with Lukoil to explore and develop tight oil in the Bazhenov," Total, last modified on May 23, 2014, <http://www.total.com/en/media/news/press-releases/russia-total-combines-efforts-lukoil-explore-and-develop-tight-oil>.

^{iv} "Shell is no longer a member," *Kommersant*, last modified on August 10, 2015, <http://www.kommersant.ru/doc/2785631>.

^v Jack Farthy and Ed Crooks, "Shale suspends Russian shale oil venture with Gazprom Neft," *Financial Times*, October 3, 2014, <https://www.ft.com/content/fc99206c-4b10-11e4-b1be-00144feab7de>

^{vi} Kenneth Rapoza, "Here's what Exxon 'lost' from Russia Sanctions," *Forbes*, last modified on February 27, 2015, <http://www.forbes.com/sites/kenrapoza/2015/02/27/heres-what-exxons-lost-from-russia-sanctions/#63ea49d356b3>.

Figure 2. Production of oil in Russia and export of oil and refined products from Russia (100 = average quarter of 2010)



Source: Rosstat, Central Bank of Russia.

* Urals oil refers to the oil brand used as the basis for pricing of the Russian export oil mixture.

for the exploration or production of shale oil, so the participation of Western major oil companies was frozen in six projects (see table 2). This did not, however, affect current hydrocarbon production. Russian companies have benefited from the ruble devaluation and managed to ramp up production and exports each quarter since 2014 (see figure 2). They have also made comprehensive investments in refining⁵⁶ that have allowed them to increase the refining depth from 71.5 percent in 2013⁵⁷ to 75 percent in 2016, aiming to reach 85 percent (the EU average level) by 2020,⁵⁸ and thus, significantly increasing the production and export of oil products and increasing export proceeds. Three Russian state-owned companies, Rosneft, Gazpromneft, and Bashneft, have expansive plans for investment in oil refining until 2020, and all of those investment projects rely crucially on Western technology.

56 “Largest ongoing investment projects in the Russian oil refinery,” *Expert*, last modified on October 10, 2016, <http://expert.ru/ratings/krupnejshie-tekuschie-investitsionnye-proektyi-v-rossijskoj-neftepererabotke/>.

57 “Novak: Russia in 2020 is to increase the depth of oil refining up to 92 percent,” *Rossiya Segodnya*, last modified on November 20, 2014, <https://ria.ru/economy/20141120/1034319461.html>.

58 “Russia by 2016 will increase the depth of oil refinery up to 75 percent,” *Rossiya Segodnya*, last modified on September 3, 2016, <https://ria.ru/economy/20160309/1387502402.html>.

Defense: Missing Pieces

Stepped-up restrictions on the sale of defense technology to Russia came in the midst of an eight-year program to retool the country’s armed forces. Some experts estimate that about 8-10 percent of Russia’s massive arms industry relies on foreign components, including some manufactured in Ukraine (making Ukraine the sixth-largest arms exporter in 2012-2013).⁵⁹ That is a relatively small share, but it tends to be concentrated in the most technologically advanced areas.⁶⁰

Deputy Prime Minister Dmitry Rogozin has said that by 2018, Russian production will replace the NATO- and EU-sourced components, mostly electronics and optics, in nearly 90 percent of the 640 pieces in which they are now used.⁶¹ Speaking to Putin in July, Deputy Defense Minister Yuri Borisov said the number would reach 826 by 2025.⁶²

A much more serious problem for the Russian defense industry (and industry as a whole) is its dependence on the import of machines—according to expert estimates, Russia imports more than 70 percent of the machines needed for the technological renovation of the defense industry, with two-thirds of that coming from six countries participating in the sanctions, Germany, Japan, Switzerland, Italy, the United States, and the Czech Republic.⁶³ The Russian government has poured tens of billions of rubles into Rostec, the state-owned corporation that oversees defense and other high-tech production and which has promised to launch production of machines shortly. Nevertheless, it will be a tall order to close the technological gap with the West, and to solve a problem that the USSR/Russia has not been able to solve for decades.

Russia’s defense industry relies much more heavily on Ukraine than on the West, especially in rockets and space, aircraft, and shipbuilding. Russia relies

59 Top list TIV Tables, Stockholm International Peace Research Institute, 2016, <http://armstrade.sipri.org/armstrade/page/toplist.php>.

60 “Government report on its performance in 2014,” The Russian Federation Government, last modified on April 21, 2015, <http://government.ru/news/17768/>; “Government report on progress 2015,” The Russian Federation Government, last modified on April 19, 2016, <http://government.ru/news/22717/>.

61 “Rogozin promised substitution of Ukrainian component in the defense industry by 2018,” *Lenta*, last modified on July 1, 2015, <https://lenta.ru/news/2015/07/01/oboronka/>.

62 Russian Defense Ministry: more than 800 models of weapons from Ukraine, NATO and the EU will be replaced,” *Tass Informational Agency in Russia*, last modified on July 16, 2015, <http://tass.ru/armiya-i-opk/2124418>.

63 Ivanov, V.P., “Machine, Machine, Machine...,” *Center Sulakshina*, last modified on January 8, 2016, <http://rusrand.ru/analytics/stanki-stanki-stanki>.



on Ukraine for the SS-18 ballistic missile, the control system of many space rockets, the targeting system for the Topol-M missile complex, gas turbines for warships, and engines for practically all types of helicopters produced in Russia, cargo planes, and training and anti-submarine aircraft.⁶⁴

This dependence, coupled with the sanctions, disrupted the supply of military products in 2015, particularly for the Russian navy. In the summer of 2015, Putin held a series of meetings on the situation, which led to a change in the structure of arms procurement, including a reduction of deliveries for the navy. Obviously, there could be other adjustments in the near future. For example, production of Russia's most modern fighter, the Su-35S, requires many imported components. The most serious dependence is in electronics, where Russia has traditionally lagged behind. In 2016, stockpiles will be used for the production of these aircraft, but in 2017, stocks will be exhausted.⁶⁵

Considering these adjustments, it is too early to determine how seriously sanctions will hit the Russian

defense industry. In the coming years, we should expect either to see evidence of their deleterious effects on production or the fruits of Russia's "import-substitution" drive.

Russia's Counter-Sanctions Against the West

In early August 2014, immediately after the launch of sectoral sanctions against Russia, Putin responded by banning the import of food from those countries levying sanctions.⁶⁶

Although Russia produces enough food and agricultural products for its own consumption, it also imports 20–40 percent of its beef, fresh fish, milk and dairy products, fruits, and vegetables, according to the Russian Statistical Committee (Rosstat).⁶⁷ It is even more reliant on Western countries for imports of high-quality products.

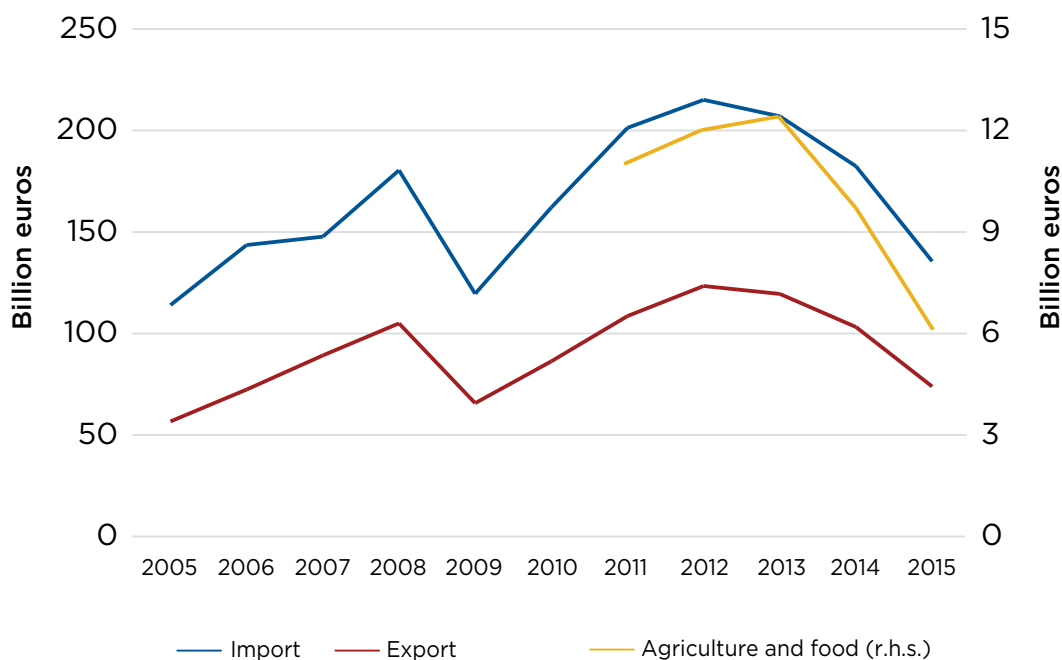
64 Vladimir Voronov, "Import substitution for Rogozin," *Radio Liberty*, last modified on January 10, 2016, <http://www.svoboda.org/content/article/27477140.html>.

65 Dennis Thalman, "'Drying' with imported filling," *Gazeta*, last modified on February 2, 2015, https://www.gazeta.ru/politics/2015/02/05_a_6400845.shtml.

66 Since January 1, 2016, Russia has imposed sanctions on imports of fruits and vegetables from Turkey, whose share in the Russian import of this products reached 25 percent after Russian counter-sanctions were imposed on EU countries. Those sanctions were imposed on Turkey in connection with the downing of a Russian military plane that was shot down by the Turkish Air Force in November 2015.

67 "Indicators of Import Substitution in Russia," Federal State Statistical Service, http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/importexchange/#.

Figure 3. EU export to and import from Russia, and export of AMA group products (billion euros/year)



Source: "Russia: Trade Report," European Commission, Directorate-General for Trade; "European Union, Trade in goods with Russia," European Commission, Directorate-General for Trade, November 4, 2016, http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113440.pdf.

The most significant effect of Russian counter-sanctions was a spike in domestic inflation—the decision to ban food imports was made suddenly and enacted the next day, which led to disruptions in the supply of products to the Russian market. According to estimates by the Russian Ministry of Economics, the additional inflation was 2.5–3 percent, but it had subsided by spring 2015.⁶⁸

As for the effect of counter-sanctions on European economies, significant drops in exports to Russia were likely due to the fall of the price of oil and the devaluation of the ruble rather than to Putin's trade ban.

Some European experts argue that Russian sanctions have seriously affected the European economy, claiming that the EU could lose 0.3 percent of GDP growth in both 2014 and 2015.⁶⁹ This assessment was based on the premise that the total decline of European exports to Russia in 2015 was caused by sanctions and

did not pay attention to the two-fold ruble collapse and 50 percent decline in overall Russian imports.⁷⁰

Other experts, who take into account the effects of ruble devaluation, note that the share of European goods among all of Russia's imports held steady under sanctions and counter-sanctions, and that the decline in imports of European goods to Russia was equal to the overall decline in imports to Russia.⁷¹ In other words, Russia bought fewer goods from Europe because Russia was buying less from everyone. Some experts, therefore, assess the economic cost of Russian counter-sanctions in terms of lost exports, and thus potentially jobs, as negligible or conclude that "Russian countermeasures have actually had a greater negative impact on Russia than on the European Union."⁷²

EU trade with Russia, both imports and exports, is directly correlated to the price of oil (see figure 3):

68 "Report of the government of the scenarios, the basic parameters of the forecast of social and economic development, price limits for services and infrastructure for 2016 and the planning period of 2017 and 2018," Ministry of Economic Development of the Russian Federation, last modified on May 28, 2015, <http://economy.gov.ru/minrec/activity/sections/macro/prognoz/201505272>.

69 Laurence Norman, "EU projects impact of sanctions on Russian Economy," *Wall Street Journal*, last modified on October 29, 2014, <http://www.wsj.com/articles/eu-projects-impact-of-sanctions-on-russian-economy-1414583901>.

70 "Balance of payments for the Russian Federation," 2016, Spreadsheet, http://cbr.ru/statistics/credit_statistics/bop/bal_of_payments_standart.xlsx.

71 Daniel Groz and Federica Mustili, "The economic impact of sanctions against Russia: Much ado about very little," *CEPS Commentary*, published on October 23, 2015, https://www.ceps.eu/system/files/DGandFM_RussianSanctions.pdf.

72 Simond de Galbert, "A Year of Sanctions against Russia—Now What?" Center for Strategic & International Studies, published on October 2015, https://csis-prod.s3.amazonaws.com/s3fs-public/legacy_files/files/publication/150929_deGalbert_SanctionsRussia_Web.pdf.

EVALUATING WESTERN SANCTIONS ON RUSSIA

In 2012-2013, fuels represented 80 percent of the overall Russian export to the EU. Therefore, the 35 percent decline in the value of Russian exports to the EU by 2015 is attributed to the decline in the value of exported fuels.⁷³ Moreover, it is not strange that Russian imports from the EU declined sharply as the price of oil collapsed, export proceeds shrank, and the ruble devalued two-fold. Moreover, the decline of European exports to Russia started in 2013, well before the annexation of Crimea, sanctions, and oil price collapse. The overall decline of EU exports to Russia in 2015 compared with 2012 is 40 percent, which is very close to the 37.5 percent drop that took place in the 2008-2009 crisis. The drop in exports in the AMA group (agricultural products, food, and fish)—though not all products of this group were subject to the Russian counter-sanctions—was 51 percent from 2012 to 2015, not crucially bigger than the overall decline in EU exports to Russia.⁷⁴ This is far from a tragedy

73 “Russia: Trade Report,” European Commission, Directorate-General for Trade, November 4, 2016, http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_111720.pdf.

74 “Russia: Trade Report,” European Commission, Directorate-General for Trade, November 4, 2016, http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_111720.pdf.

for the European economy. The value of food exports from the EU as a whole to all non-EU countries grew by 3 billion euros in 2014 and 5.5 billion euros in 2015, offsetting any decline in exports to Russia.

It is fair to say, then, that the effects of Russian counter-sanctions have been marginal for the EU as a whole and have been concentrated in neighboring countries, such as the Baltics and Finland,⁷⁵ for whom Russia is historically a major trading partner and whose political leaders have not complained about the burden of sanctions.

[doelib/docs/2006/september/tradoc_111720.pdf](http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_111720.pdf); If AMA export to Russia declined the same 40 percent as overall export, it would be only 1.8 billion euros bigger, and statistically, that is the effect of Russian sanctions on the EU economy.

75 Data for individual European countries says that only 4 out of 28 EU members recorded the severe cuts in the food export out of the EU (that may be attributed to Russia) where exports in 2015 declined significantly compared to both 2013 and 2014. Those countries are Finland (-35 percent), Lithuania (-29 percent), Latvia (-16 percent), Estonia (-13.5 percent), and Poland (-3.7 percent).

POLITICAL COSTS

However, we should not overlook another effect of sanctions that cannot be measured by statistics, at least in the short run. While financial sanctions have inflated the cost of capital for the Russian economy, the political pressure on Russia has dramatically increased the political risks of doing business there. Indeed, the flow of Western investment projects and innovation into Russia has slowed to a trickle. This lack of access to technologies and human capital is much more sensitive for the Russian economy in the medium- and long-run. The country's industrial and technological infrastructure will require massive innovation if the economy is to become competitive. Historically, Russia (and the Soviet Union) has relied on imports of technologies to all industries except defense. The Kremlin's dream of huge investment in the development of technologies and import

substitution, *importozameschenie*, requires massive financial resources, which are unlikely given the budget constraints, as well as development time, with no guarantee that the resulting products and technologies would be operative, let alone competitive outside Russia.

This combination of Western sanctions and increased political risks, together with the Kremlin's aspiration to build an economy independent of the outside world will inevitably lead to the growing isolation of the Russian economy, a widening technological gap, lagging competitiveness, and slower growth. Those effects are not visible now but in five to seven years, if sanctions are not removed, they will become the main legacy of sanctions and will exact a heavy cost on Russia's economy.

POLICY RECOMMENDATIONS

If the policy goal of Western sanctions against Russia is to change Russian policy on Ukraine and if sanctions are to remain as the preferred policy tool, then the United States and the EU must not only renew sanctions but escalate them. Only a stricter and more comprehensive sanctions regime, as demonstrated by the successful sanctions program against Iran,⁷⁶ could change the Russian calculus on Ukraine. The West could consider the following:

TIGHTEN PERSONAL SANCTIONS

- Close loopholes that allow individuals and entities to circumvent existing sanctions;
- Expand sanctions to include all members of the Russian Federation Council who voted to allow the use of Russian troops in Ukraine as well as Russian companies and governmental agencies and their managers operating in Crimea;⁷⁷
- Direct financial institutions to freeze the assets of close relatives of those under sanctions to counteract the widespread practice of evading sanctions by transferring assets. Sanctioned individuals and their close relatives should not be allowed to invest, live, or buy real estate in the West;⁷⁸
- Reform the criteria for determining which companies are controlled by people or entities under sanctions in order to prevent companies from circumventing sanctions by concealing their true ownership; and
- Assist the job of the Joint Investigation Team (JIT) on the MH-17 case in order to expedite the criminal investigation; assist Ukraine, Netherlands, and Malaysia in establishing an international court for this crime.

76 Zachary Laub, "International Sanctions on Iran," Council on Foreign Relations, last modified on July 15, 2015, <http://www.cfr.org/iran/international-sanctions-iran/p20258>.

77 E.g., the Central Bank of Russia has opened three of its cash and settlement centers in the Crimea, which allow the Russian banks to operate in the occupied peninsula. However, all of the managers of the Bank of Russia are included on the sanctions lists.

78 E.g. Gennady Timchenko, one of Putin's closest cronies, is on the US sanctions SDN list while not on the EU's list; two of Putin's other cronies, brothers Arkady and Boris Rotenberg, are on the US SDN list. Roman Rotenberg, the son of Boris, is on the SDN list as well, while Arkady's son Igor, who receives his main assets from his father, is not on the sanctions list.

EXPAND FINANCIAL SANCTIONS⁷⁹

- Systematically apply sanctions to all state-controlled banks in Russia, including subsidiaries such as the VTB Bank subsidiaries in London, Paris, Frankfurt, Vienna, and New York (though subsidiaries in Belarus and Armenia are under sanctions)
- Gazprom should be added to the European financial sanctions list
- Ban Russian state-owned banks from making or receiving international payments (in US dollars, euros, British pounds, Swiss francs, etc.) which would require freezing their correspondent accounts in equivalent currencies and barring them from opening new ones.⁸⁰ This measure was used against Iran and Libya to good effect
- Ban Western financial institutions from providing capital to the Russian government in international and domestic markets. The budgetary situation in Russia is deteriorating fast, and the Russian Finance Ministry is looking to borrow more aggressively in the domestic and foreign markets. A ban on access to Western capital would increase the costs of the Kremlin's aggressive policy

INCREASE THE COST ON RUSSIA'S ENERGY SECTOR

- Restrict the export of Russian raw materials, primarily hydrocarbons, through an embargo on the purchase of crude oil from Russian state-owned companies (Rosneft, Gazpromneft, and Bashneft), which account for slightly more than half of Russian oil exports. Even if Russia is able to sell its oil elsewhere, it will cost it more to do so, correspondingly reducing the financial resources of Putin's regime

79 Throughout this report, we have intentionally left aside ideas that, in our view, are simply not feasible, such as a ban on Russian banks accessing SWIFT or freezing the assets and accounts of the Central Bank of Russia. The first idea requires comprehensive support of the banking community (as SWIFT is a partnership of banks), which, in our estimation, is lacking. The second idea is "a nuclear option" that will destructively damage the whole Russian economic system and wreak havoc on the Russian financial market by collapsing the ruble and spurring rapid inflation.

80 Legally, it could be done by including such banks on the SDN List.

EVALUATING WESTERN SANCTIONS ON RUSSIA

- Sectoral sanctions should be imposed on Russian liquefied natural gas (LNG) projects, which rely on Western technologies and managerial expertise. Sanctioning countries should not purchase or trade in Russian LNG
- Sectoral sanctions should be imposed on Russian state-owned oil companies (Rosneft, Gazpromneft, and Bashneft), which use Western technology extensively. Additionally, the sectoral sanctions should be extended on Russian state-owned oil companies that rely heavily on imported goods and services in hydrofracture and drilling (in some cases, the share of import reaches 85-95 percent).⁸¹
- In addition to tightening and expanding personal, financial, and sectoral sanctions, the West should take a stronger public stance to condemn Russia's war in Ukraine. First, as long as sanctions are tied to the Minsk-2 agreement, intelligence agencies in Europe and the United States should systematically publicize Russia's Minsk-2 violations, for which there should be clearly defined consequences. Second, rather than sanctions being renewed by a vote every three to six months, the protocol should be revised for sanctions to remain indefinitely until canceled or mitigated only by the unanimous decision of EU members.

⁸¹ Sergey Alexeev, "Dangerous Dependence," *RBC-Daily*, last modified on November 2, 2016, <http://www.rbcplus.ru/news/581905087a8aa916abe9ce40>.

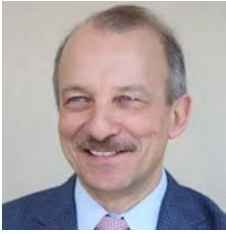
CONCLUSION

Relations between Russia and the West are at a standstill without a clear way forward. Still, Western leaders must not be content to maintain the status quo in eastern Ukraine, which could set a dangerous precedent for further unilateral changes of international borders by other states. For example, China is playing similar territorial games in its increasingly tense neighborhood.

If the West cannot compel Russia to fulfill the Minsk-2 agreement in the near future, military force could again become an acceptable instrument of foreign policy, ready to be used by countries around the world. The political instruments used by the West to pressure Russia have had little effect and have not changed

Putin's aggressive policies. Sanctions designed in mid-2014 did not significantly increase the costs of Russian foreign policy and did not clearly affect the Kremlin's behavior. If sanctions remain unchanged (let alone partially removed or loosened), their effectivity will fade, and this will demonstrate the West's inability to impede a serious crisis provoked by Russia. If, however, the West wants to demonstrate that sanctions can be a valuable and important instrument in foreign policy, then it needs to escalate the scope of sanctions and their pressure on Russia and significantly increase the costs of Putin's aggressive policy.

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Sergey Aleksashenko is a nonresident senior fellow for global economy and development at the Brookings Institution. Prior to this role, Dr. Aleksashenko served as deputy minister of finance of the Russian Federation in charge of budgetary planning and taxation, and as the first chairman of the Central Bank of Russia in charge of monetary policy. While working for both the Russian Central Bank and the Ministry of Finance, Dr. Aleksashenko was in charge of negotiations with the International Monetary Fund. He was also a scholar-in-residence in the Carnegie Moscow Center's Economic Policy Program. His research focused on Russia's integration into the global economy and its recovery from the global financial crisis, including analyzing the causes and potential long-term consequences of the crisis for the country and the measures taken by the Russian government to stabilize the situation. Dr. Aleksashenko was previously the director of macroeconomic research at Moscow's Higher School of Economics at the National Research University, a position he has held from 2008 to 2014; president and CEO of Merrill Lynch Russia; president and member of the board at Antanta Capital; and managing director of Interros, a Russian private investment company, from 2000 to 2004. Dr. Aleksashenko has served as a member of the boards at major Russian banks and companies (Sberbank, Norilsk Nickel, Aeroflot, etc.). He is the author of numerous articles on Russia's economy and is also the author of *Battle for the Ruble*.

APPENDIX

US SANCTIONS

DATE	Individual	Financial	Sectoral
February 22, 2014	Ukrainian President Yanoukovich flees the country, Russian troops are deployed in Crimea		
March 5-6, 2014	President Obama signs EO 13660 (undermining Ukrainian sovereignty and integrity)		
March 16, 2014	Referendum in Crimea		
March 16-17, 2014	President Obama signs EO 13661 (Russian politicians, cronies, defense industry)		
March 18, 2014	President Vladimir Putin signs annexation agreement with Crimea		
March 20-21, 2014	President Obama signs EO 13662 (sectoral sanctions)		
	20 individuals (16 Russian politicians + 4 Putin's cronies) + 1 bank owned by sanctioned individuals (EO 13661)		
April 11, 2014	7 individuals + 1 company (EO 13660)		
April 28-29, 2014	7 individuals + 14 companies + 3 banks + 1 bank owned by sanctioned individuals (EO 13661)		Export restrictions on high technologies articles and services regulated by USML that contribute to Russia's military capabilities, including revoking of existing licenses
May 12, 2014			
June 20, 2014	7 individuals (EO 13660)		
June 23, 2014			
July 11, 2014			
July 16, 2014	1 individual + 2 entities + 1 company (EO 13660); 4 individuals (EO 13661); 8 companies from arms or related materials sectors (EO 13661)	2 banks (Gazprombank, VEB) + 2 energy companies (Novatek, Rosneft) (EO 13662)	

EU SANCTIONS

DATE	Individual	Financial	Sectoral
February 22, 2014	Ukrainian President Yanoukovich flees the country, Russian troops are deployed in Crimea		
March 5-6, 2014	EU Council Decision 2014/119 (undermining democracy, misappropriation of Ukrainian property, violation of human rights)		
	18 individuals (EU CD 2014/119)		
March 16, 2014	Referendum in Crimea		
March 16-17, 2014	EU Council Decision 2014/145 (Russian politicians, cronies)		
	21 individuals (EU CD 2014/145)		
March 18, 2014	President Vladimir Putin signs annexation agreement with Crimea		
March 20-21, 2014	12 individuals (EU CD 2014/145)		
April 11, 2014			
April 28-29, 2014	15 individuals (EU CD 2014/145)		
May 12, 2014	13 individuals + 2 entities (EU CD 2014/145)		
June 20, 2014			
June 23, 2014	Council Decision 2014/386 (Ban on import of goods from Crimea or Sevastopol)		
July 11, 2014	11 individuals (EU CD 2014/145)		
July 16, 2014		Suspends new financing operations by the EIB	

EVALUATING WESTERN SANCTIONS ON RUSSIA

July 17, 2014	Malaysian Airlines Flight MH-17 is shot down in the Donbas		
July 25, 2014			
July 29-31, 2014	1 company from arms or related materials sectors (EO 13661)	3 banks (Bank of Moscow, Rosselkhozbank, VTB) (EO 13662)	
September 5, 2014	Minsk-1 agreement is signed		
September 11-12, 2014	5 companies from arms or related materials sectors (EO 13661)	1 bank (Sberbank) + 2 energy companies (Gazpromneft, Transneft) + 1 arms sector (Rostec) (EO 13662)	Deepwater oil exploration 5 energy companies (Gazprom, Gazpromneft, Lukoil, Surgutneftegaz, Rosneft) (EO 13662, directive 4)
November 29, 2014			
December 19, 2014	President Obama signs EO 13685 (Ban on exporting from, importing to, or investing in Crimea)		
	17 individuals + 7 entities (EO 13660)		
February 12, 2015	Minsk-2 agreement is signed		
February 16, 2015			
March 11, 2015	11 individuals + 1 entity (EO 13660); 1 bank (EO 13685)		
July 30, 2015	4 individuals + 1 company (EO 13660) ; 15 individuals + 8 entities (EO 13661) ; 6 companies (EO 13685)	Subsidiaries of Rosneft and VEB are identified (EO 13662)	
March 19-20, 2015	The EU summit decided to align the existing sanctions regime to the implementation of the Minsk agreements		
December 22, 2015	8 individuals (EO 13660); 4 individuals + 10 entities (EO 13661); 12 entities (EO 13685)	Subsidiaries of Rostec, Sberbank and VTB are identified (EO 13662)	
September 1, 2016	17 individuals + 1 entity (EO 13660); 1 entity (EO 13661); 18 entities (EO 13685)	Subsidiaries of Bank of Moscow and Gazprombank are identified (EO 13662)	Subsidiaries of Gazprom are identified (EO 13662, directive 4)
November 14, 2016	6 individuals (EO 13660)		

EVALUATING WESTERN SANCTIONS ON RUSSIA

July 17, 2014	Malaysian Airlines Flight MH-17 is shot down in the Donbas		
July 25, 2014	15 individuals, 9 entities (EU CD 2014/145)	9 companies in Crimea that were transferred to Russian ownership in violation of Ukrainian law	
July 29-31, 2014	EU Council Decision 2014/512 (sectoral sanctions)		
	6 individuals + 3 entities (EU CD 2014/145)	5 banks (Sberbank, VEB, Gazprombank, Rosselkhozbank, VTB)	Ban on trade in arms and related materials, ban on export of dual-use goods for military end users; ban on export of deep oil exploration and production
September 5, 2014	Minsk-1 agreement is signed		
September 11-12, 2014	Amendment to Council Decision 2014/512 (sectoral sanctions; deepwater exploration)		
	24 individuals (EU CD 2014/145)	3 defense companies, 3 energy companies (Gazpromneft, Transneft, Rosneft)	Ban on dual use goods and technologies for 9 defense companies Ban on Deepwater oil exploration and production projects in Russia
November 29, 2014	13 individuals and 5 entities (EU CD 2014/145)		
December 19, 2014	Amendment to Council Decision 2014/386 (Ban on investment, provision of goods and services to some sectors in Crimea or Sevastopol)		
February 12, 2015	Minsk-2 agreement is signed		
February 16, 2015	19 individuals + 9 entities (EU CD 2014/145)		
March 11, 2015			
July 30, 2015			
March 19-20, 2015	The EU summit decided to align the existing sanctions regime to the implementation of the Minsk agreements		
December 22, 2015			
September 1, 2016			
November 14, 2016	6 individuals (EU CD 2014/119)		

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