Sanctions and countersanctions – effects on economy, trade and finance

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In this paper we review the history and current state of sanctions imposed on Russian entities by the EU, the U.S.A. and others, as well as Russia's countersanctions. We try to assess what kind of economic effects these measures have had, although any such analysis is bound to be confounded by the large drop in the price of oil that occurred in 2014 and 2015. We find that sanctions have had a clear, negative effect on the Russian economy, although the decline in the price of oil affected Russian GDP much more strongly in 2014–2016. The U.S. and EU sanctions have worked e.g. by restricting Russian banks' access to capital. EU countries' trade with Russia and their market share in Russia have declined, but this is partly a continuation of a long-term trend. Russia's countersanctions have e.g. affected exports of foodstuffs from the EU, but macroeconomic effects in the EU are very small.

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We review various economic effects of the sanctions and countersanctions introduced by the U.S.A., EU, Russia and other countries following Russia's illegal annexation of the Crimean Peninsula and Russia's actions in destabilizing the situation in eastern Ukraine. The restrictive measures of various parties in the conflict have been very asymmetrical: The U.S.A. and EU have mostly limited some Russian entities' access to market finance as well as exports of some technologies, while Russia has banned imports of agricultural goods from various countries. One can also see Russia's import bans as part of its self-proclaimed "import substitution" policy.

It is difficult to isolate the impact of the sanctions, but their role in the recent downturn of the Russian economy seems to be notably smaller than that of the oil price decline. While, generally speaking, the impact of sanctions has been relatively limited on the aggregate level, they have had more noticeable effects on directly affected companies and individuals. In the case of the EU, the aggregate impact of sanctions is also limited, but certain individual sectors and companies have been hit harder. Obviously, the food sector suffered from the effects of Russia's sanctions, at least in 2014 and 2015, even if most subsectors have been able to reorient their extra-EU exports elsewhere.

It should be noted, however, that our conclusions are not evaluations of the effectiveness of the sanctions imposed on Russia, e.g. by the EU. The goal of the economic sanctions imposed by the EU is not to make the Russian economy collapse or to impoverish the Russian people, which is also reflected in the relatively narrow targeting of the sanctions. They are meant to influence policy, e.g. promote the implementation of the Minsk agreements. It is beyond the scope of this paper to assess how much effect the sanctions have had on policies, but the reader should remember that, in the absence of sanctions, Russia's policies could have been quite different and taken an undesired direction.

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This article is structured as follows. In the first section, we describe sanctions imposed by different countries. The second section tries to assess the macroeconomic effects of sanctions on Russia. In the third section, we offer evidence on various sanctions' effects on international trade and capital movements. The fourth section concludes.

1 Sanctions and countersanctions

1.1 Rationale for and design of sanctions[2]

After the illegal annexation of Crimea and the start of military operations in eastern Ukraine, many Russian entities and persons were subjected to different economic and financial sanctions by the EU, the U.S.A. as well as other countries such as Canada, Australia and Norway. Initially, sanctions were relatively mild.[3] Typically, different political and economic acts were deemed to be "undermining Ukraine's territorial integrity," and persons and institutions involved in such acts were added to the sanctions list. The sanctions related to the annexation of Crimea are legally separate from the later sanctions.

The downing of Malaysian Airlines flight MH-17A caused a clear tightening of sanctions. While some of the response measures taken by the EU and U.S.A. differed in terms of timing, generally their measures have been very synchronized. Many institutions as well as many individuals were added to the EU sanctions list on July 30, 2014.

Sanctions were adopted in many sectors. In the trade sector, the export and import of arms was forbidden, as was the export of dual-use goods for military use. In addition, exports of certain types of goods related to oil exploration and production were banned.

Perhaps even more significantly, the long-term financing of several Russian companies was curtailed, even if they had no direct involvement with the fighting in the Donetsk and Luhans'k regions. Investors in the EU were forbidden to provide long-term financing to Sberbank, VTB, Gazprombank, Rosselkhozbank (Russian Agricultural Bank) and VEB (Russian state-owned development bank). The long-term financing ban also affects the oil giant Rosneft, the oil pipeline company Transneft and Gazprom Neft as well as certain companies operating in the military sector.

1.2 Russia's rationale for countersanctions

The groundwork for Russia's countersanctions was laid in the late 2000's, well before the events in 2014. The food security doctrine, a framework policy paper outlining Russia's goals in agricultural policies, was signed in conjunction with the new national security concept in January 2010. Russia's food security policy reflects a worldview according to which dependence on imports is dangerous. This differs from most other countries, where food security tends to be defined in terms of securing access to adequate and affordable food intake for the population (Wegren and Nikulin, 2016). The Russian doctrine establishes minimum targets for domestic production of basic foodstuffs such as potatoes, dairy products, grain

[2] *This section draws heavily on Korhonen (2018). For an insightful assessment of various criteria for designing sanctions against Russian entities, see Christie (2016).*

[3] *For a comprehensive and up-to-date listing of the EU's restrictive measures, see https://europa.eu/newsroom/highlights/special-coverage/eu-sanctions-against-russia-over-ukraine-crisis_en.*

as well as meat and meat products. The general guidelines of the food security doctrine were later formulated into an action plan that was approved in 2012 (Development Program for Agriculture 2013–2020).

Import substitution is, however, not limited to the agriculture and food industry sectors. A very broad policy document setting out the "Government Program on Industries and Competitiveness" was approved in April 2014[4]. This document outlines detailed plans on almost all industries; it was prepared to increase domestic production and R & D with the help of e.g. budget money and localization requirements. The document has also been dubbed the "import substitution program" of the Russian government.

All these policy programs reflect the broadly held view in Russian administration that import substitution is important in fostering economic growth. Restricting imports of selected food products from countries imposing sanctions on Russia in July 2014 was a logical continuation of these policies.

Restrictions on imports from the EU, the U.S.A. and Turkey, a devaluation of the Russian ruble and various state support programs have indeed helped boost domestic production especially in agriculture. However, in several sectors these positive trends for Russia predate countersanctions by a wide margin. Favorable weather conditions partly explain the extremely good harvests in 2016 and 2017, but fruit and vegetable crop yields have been increasing steadily since 2010.

One could possibly imagine Russia lifting some import restrictions if political tensions were to ease markedly. However, even if outright bans were to be lifted, there is always the possibility of misusing various nontariff barriers such as phytosanitary inspections.

2 Macroeconomic and trade effects of sanctions

2.1 Effects on Russia

In this subsection we will review some evidence on the macroeconomic effects of the sanctions on Russia. At the outset it should be noted that trying to estimate the effects of sanctions is fraught with difficulties, especially in a situation where the price of energy, Russia's most important export product, has also collapsed.

Russia's GDP growth started to clearly decelerate already in late 2012, and in 2013 GDP increased only by 1.8%. During 2014, quarterly growth rates turned negative. All in all, Russia's GDP declined by approximately 3% between 2014 and 2016. In 2017, slow growth resumed, and GDP increased by 1.5%. For 2018, most forecasts see relatively slow growth continuing.

Despite the aforementioned difficulties in separating the effects of the sanctions from all other factors influencing Russia's GDP growth, some attempts have been made. The International Monetary Fund (2015) reports that the sanctions against Russia and (Russia's) countersanctions could initially reduce Russia's real GDP by 1% to 1½%. In the medium term, Russia's cumulative output loss could be as high as 9%. It should be noted that such a large loss in the level of GDP presupposes lower levels of investment and productivity growth (as Russia's own inward-looking policies lead to a lower level of competition).

Gurvich and Prilepskiy (2015) gauge the effects of financial sanctions on the availability of finance for Russian companies. Looking forward, Gurvich and

[4] *http://government.ru/docs/11912/.*

Prilepskiy formulate four different scenarios for different combinations of sanction regimes and oil price. They find that the cumulative effect of sanctions on Russian GDP from 2014 to 2017 is 2.4 percentage points. However, the negative effects of low oil prices are three times larger than this.

As for the effects of Russia's food embargo on Russians themselves, Volchkova (2018) reports that the average Russian has had to decrease consumption of the embargoed foodstuffs by 2,000 rubles per year. The average monthly wage in 2017 was 39,150 rubles.

2.2 Effects on Russia's foreign trade

Fritz et al. (2017) look at Russia's imports from different countries and find that all sanctions (both Russian and Western) have reduced EU exports to Russia by 11%. Obviously, different EU countries are being affected differently, with Germany bearing the largest absolute loss of exports, while relative losses were large e.g. in Poland, Hungary, the United Kingdom and Greece. From these trade loss estimates, Fritz et al. (2017) also calculate that the EU has lost less than 0.2% of its value added and employment because of the sanctions.

Crozet and Hinz (2017) estimate global trade losses stemming from EU and Russian sanctions introduced in 2014. They find that global lost trade amounts to USD 4.8 billion per month[5], with USD 1.8 billion being borne by sanctioning Western countries, mostly the EU. This drop consists mostly of goods that are not directly embargoed.

3 Effects on goods and services trade and capital flows

3.1 Russian goods imports declined across the board

Russian imports are mainly determined by the demand of companies and households as well as the ruble exchange rate. During the recent crisis, fixed investment in Russia fell by 13% in real terms, from peak to trough, and household consumption by 12%. The ruble's average annual exchange rate depreciated by over 40% against the euro and by over 50% against the USD in 2014–2016. Due to declining demand and the sharp depreciation of the ruble, Russian imports from all countries notably declined after 2013 (chart 1). Correspondingly, in 2017, as the economy started to recover and the ruble strengthened, Russian imports from all countries increased again.

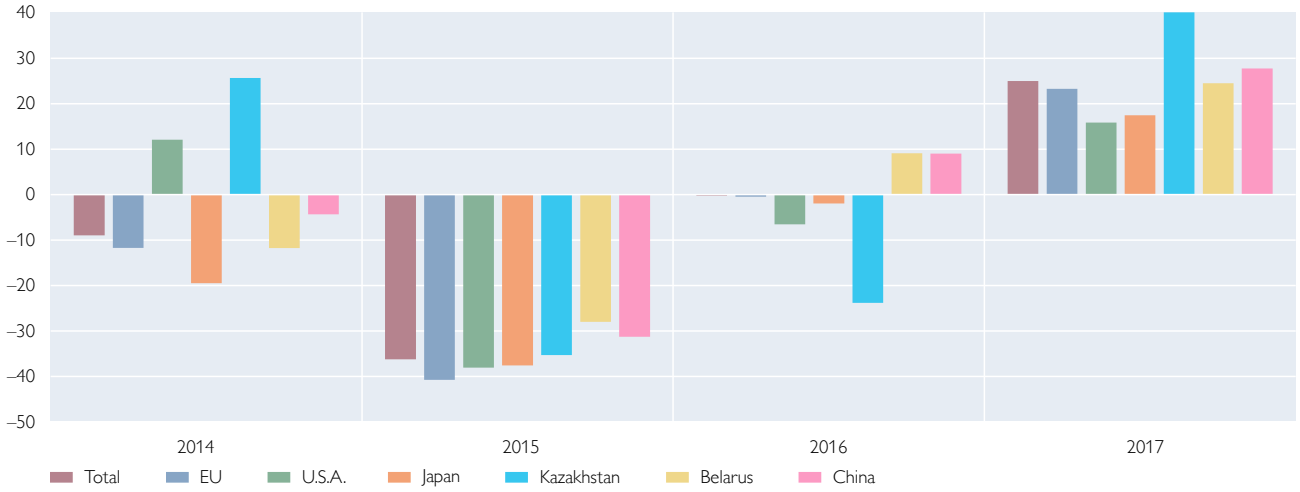
In the past years, the EU has lost market share in Russia, especially to China, but mainly for reasons other than sanctions. The loss in market share reflects the continuation of a longer-term and geographically wider trend, as China has been rising as the largest exporter in the world. While the average share of the EU-28 in Russian imports fell from 46% in 2006–2009 to 39% in 2014–2017, the average share of China increased from 13% to 20%. The growth of China's market share in Russia has actually slowed down slightly in the most recent years compared to faster gains in previous years.

[5] *However, data do not include Russian imports from China or Korea.*

Chart 1

Change in the USD value of Russian goods imports by country, 2014–2017

Year-on-year change in %



Source: CEIC, Russian customs data.

Note: According to U.S. data, the value of U.S. exports to Russia declined by 3.5% in 2014 instead of increasing by 12% as indicated by Russian data. For 2015 and 2016 the changes are similar in both statistics.

3.2 EU export restrictions focus on a few products

The export restrictions imposed by the EU target a quite narrow assortment of products and therefore their impact on the total exports of the EU countries is in most cases limited. The EU has banned exports of the following goods to Russia: arms, dual-use products for military use and certain products related to deep-water, Arctic offshore and shale oil exploration and production. It is difficult to assess the magnitude of restricted exports due to data limitations, but it seems to be relatively modest in most cases.

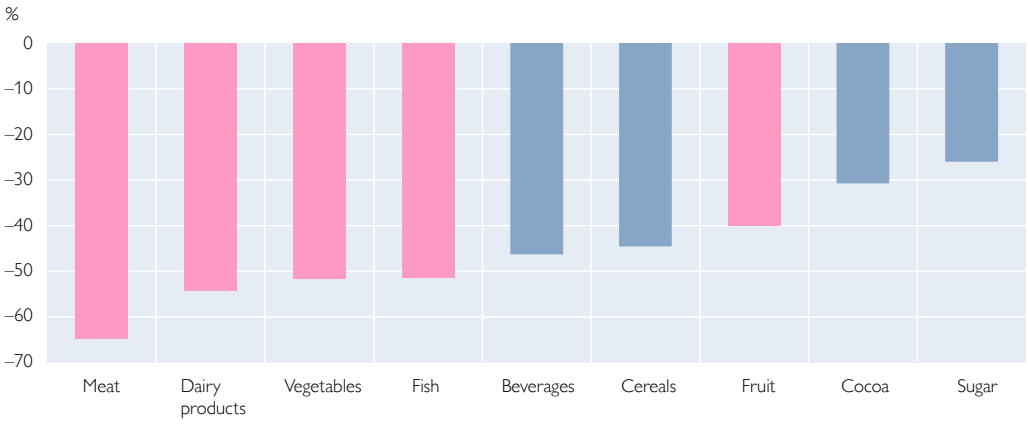
According to the arms trade figures published by the EU, the combined value of arms exports to Russia recorded by the 12 countries reporting the figures was about EUR 90 million in 2013. There might be considerable variation by country and year, however. Exports of dual-use goods for military end use cannot be separated from public trade statistics and therefore it is difficult to estimate their value. The EU-28's total exports of oil exploration and production technologies subject to restrictions were about EUR 350 million in 2013 (0.02% of total extra-EU exports), but as noted above, only a part of this export aggregate is subject to export bans. Summing up, these figures suggest that the overall impact of EU export restrictions is quite limited.

3.3 Russian import restrictions have affected food trade significantly – but the weak ruble has also played a role

In August 2014, Russia banned several foodstuff imports from certain countries, including the EU. These bans practically ceased Russian imports of these products from these countries. However, imports of all foodstuffs were also hit hard by declining demand and especially the depreciation of the ruble in 2013–2016 (chart 2). The import bans and ruble depreciation to some extent supported domestic production, which replaced some imports. Some of the banned imports

Chart 2

Change in the value of Russian imports of certain foodstuffs, 2013–2016



Source: UN Comtrade.

Note: Pink bars depict products subject to import restrictions, blue bars show products that are not subject to any restrictions.

were substituted with imports from other countries, resulting in a heavy geographical concentration of Russian imports in many of the products subject to import restrictions. For example, Belarus accounted for over 80% of Russian dairy product imports in 2016.

From the EU's point of view, the overall economic impact of the import bans has been limited, as the share of the affected products in EU exports to Russia had been relatively small even before the restrictions. In 2013, the total value of the EU-28's exports of (now) banned food products to Russia was EUR 5.2 billion, accounting for 0.3% of the EU-28's total external exports. Cessation of the exports of food products banned by Russia accounted for about one-third of the loss in the EU's market share in Russia between 2013–2016.

The value of banned food exports varied quite much across EU countries from a mere EUR 1 million in Romania to over EUR 900 million in Lithuania[6]. In relative terms, the banned products on average accounted for 0.9% of the extra-EU exports of the individual EU countries. But in certain countries (e.g. the Baltic countries and Finland) the negative impact on certain individual sectors and companies has been notable, as Russia is among the most important export markets for these countries.

Despite some media reports, a circumvention of Russian import bans by exporting goods through Belarus does not seem to be a major issue in the case of EU exports. The value of food products banned by Russia that the EU-28 exports to Belarus increased by a mere EUR 70 million in 2014–2015, whereas in 2016–2017 it declined and fell below the level of 2013.

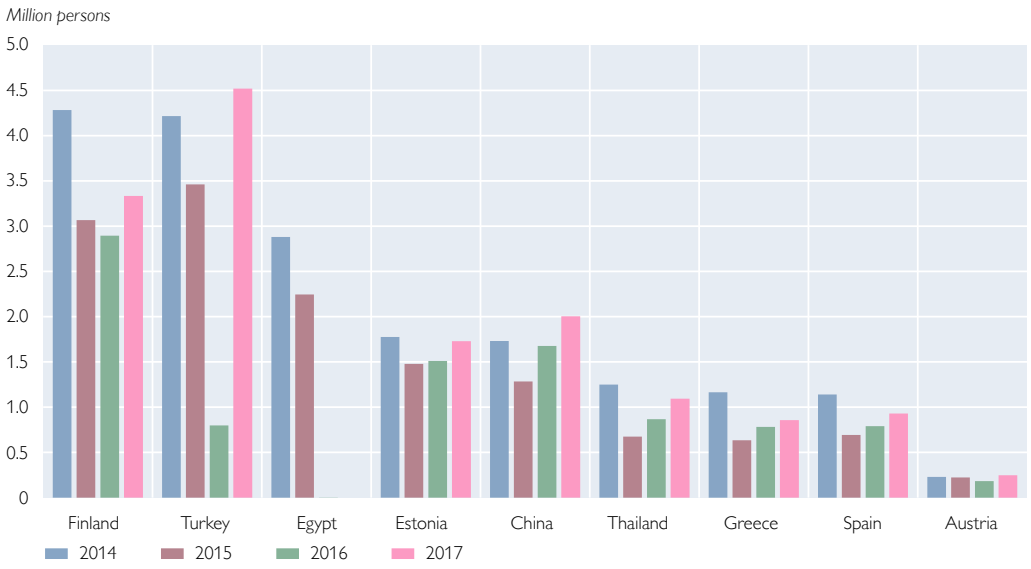
3.4 Services trade not much restricted by sanctions

The virtually only sanctions imposed on trade in services between the EU and Russia are the restrictions imposed by the EU on exports of certain services related to oil exploration. These particular services cannot be extracted from overall statistics, but it is obvious that the direct impact of sanctions on trade in services is

[6] *A large part of Lithuanian exports are, however, actually re-exports.*

Chart 3

Russian tourist flows to certain countries



Source: CEIC.

very limited. This is again reflected in the fact that Russian imports of services have contracted across most countries, irrespective of mutual sanctions. The USD value of Russian service imports from the EU-28 decreased by 36% in 2014–2016 compared to a fall of 47% in the aggregate of all other countries. Last year, the service imports from the EU recovered nearly at the same pace as those from other countries.

As an example of service trade, we can take tourism. Due to declining income and a sharp depreciation of the ruble, the average monthly revenue of Russian households nearly halved in USD terms in 2014–2016, weighing heavily on tourist flows abroad. There are practically no sanctions imposed on mutual trade in tourist services by the EU or Russia, but Russia has lately implemented travel restrictions on Turkey and Egypt[7], which has indeed had a notable effect on Russian tourism to these destinations (chart 3).

3.5 Capital flows and sanctions

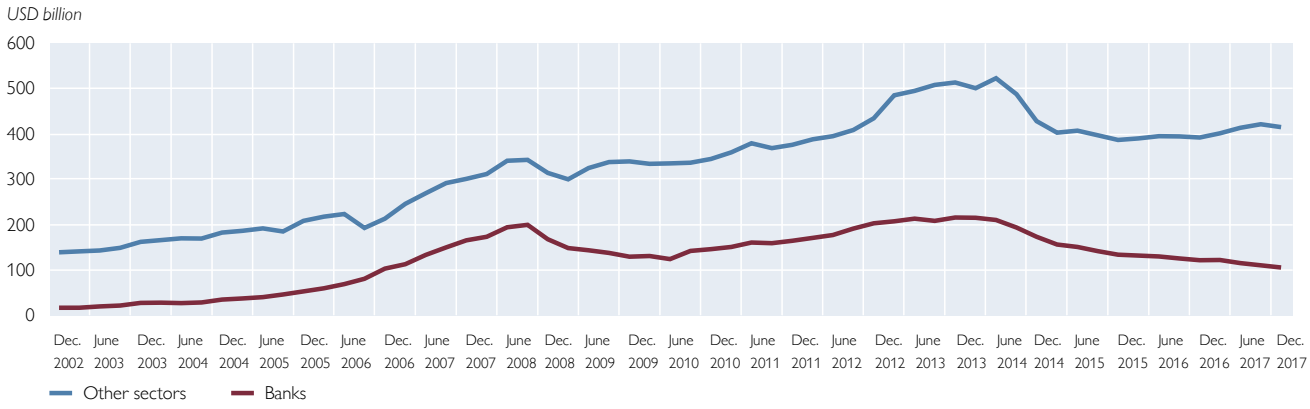
For many Russian companies, access to external finance from the U.S.A. and EU has been limited since the third quarter of 2014. Private sector net capital outflow increased rapidly, especially in the fourth quarter of 2014, nearly tripling in 2014 to a record level of USD 152 billion. The annual net outflow has remained negative ever since.

Many Russian companies and especially banks found it difficult to refinance their foreign loans falling due in 2014 and 2015. Chart 4 shows the foreign debt of Russian commercial banks and other sectors. We can see that gross foreign debt

[7] *Russia banned charter flights to Turkey at end-2015 as part of its sanctions against Turkey due to the downing of a Russian fighter plane. The ban was lifted in autumn 2016. Flights to Egypt were suspended after a plane with Russian tourists was crashed in Egypt in late 2015 due to a terrorist attack. The flights to Egyptian tourist destinations are expected to resume in autumn 2018.*

Chart 4

Foreign debt of Russia's banks and other sectors



Source: Bank of Russia.

decreased by some USD 210 billion from end-2013 to end-2017. Especially banks' foreign debt has decreased, and here sanctions must play a role, as the largest Russian banks are subject to financial sanctions. The foreign debt of banks has gone back to a level last observed in 2006.

According to consolidated data on cross-border bank lending compiled by the Bank for International Settlements[8], foreign banks' claims on Russian entities were USD 122.4 billion, down slightly more than 50% from end-2013. This illustrates how foreign banks have drastically decreased their exposure to Russia.

During the period from 2014 to 2016 inward foreign direct investment into Russia also declined. Between 2010 and 2013 the average FDI net inflow was USD 54.5 billion per year, while it declined to USD 22 billion in 2014 and further to USD 7 billion in 2015. After this, FDI started to increase again, although FDI net inflow is still far below the pre-crisis and pre-sanctions level.[9]

4 Concluding remarks

In this article we have reviewed sanctions imposed by the EU, the U.S.A. and Russia in the aftermath of Russia's illegal annexation of Crimea and its military presence in eastern Ukraine, and have examined the economic effects of these sanctions. Previous literature reveals that sanctions have had a negative effect on the Russian economy, although all available evidence suggests that between 2014 and 2016 the decline in the price of oil had a much larger effect on the Russian economy. At the same time, it is possible that if sanctions remain in place for an extended period, and especially if Russia intensifies its import substitution policy, Russia's long-term growth potential may be diminished.

Exports to Russia from the EU, the U.S.A. and other countries applying sanctions have declined in past years. We show that the direct effect of sanctions on

[8] *https://www.bis.org/statistics/rppb1804.htm.*

[9] *By far the largest sender of FDI into Russia is Cyprus, with 32% of total inward FDI stock – USD 499.7 billion – at the end of September 2017. It is generally agreed that this is mostly Russian money round-tripping via Cyprus. Other large offshore centers/tax havens sending FDI into Russia are e.g. Luxembourg (10.3% of total), the Bahamas (6.5%), Bermuda (4.3%), the British Virgin Islands (2.7%) and Jersey (2.2%). Germany accounts for 3.8% of inward FDI stock, the U.K. for 3.7%, France for 3.1%, Austria for 0.9% and Finland for 0.8%.*

this decline in exports was limited; the main factors behind the decline were contracting demand in Russia and a substantial depreciation of the ruble. Bans on long-term financing have affected Russian banks' access to financing.

Many EU sanctions are linked to the Minsk peace process and its implementation, which currently seems quite distant. At the same time, Russia's food import bans seem to have become part of its overall import substitution policy. These two facts alone imply that various sanctions on bilateral economic activities between the EU, the U.S.A. and other countries, on one side, and Russia on the other, will remain in place for a good while.

On April 6, 2018, the U.S.A. introduced additional sanctions against various Russian individuals and corporations "in response to worldwide malign activity." This provoked sharp market reactions in the following days. The ruble lost around 10% of its external value, and the share price of Rusal, one of world's largest aluminum producers and one target of the sanctions, dropped by more than 50%. These developments suggest that further rounds of sanctions are also possible.

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