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ECONOMIC SANCTIONS AGAINST RUSSIA:**

**DO THEY WORK OR SHOULD THEY BE
STRENGTHENED?**

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The Ukrainian Crisis and Western Economic Sanctions against Russia:

Do They Work or Should They Be Strengthened?

Dr. Randall E. Newnham

After a year of chaos, the conflict in eastern Ukraine continues to simmer. How can it be brought to an end? How can Russia be made to stop its intervention in Ukraine? With many Western leaders, especially in Europe, explicitly denying that any military measures can be contemplated, only economic leverage seems to offer any hope of forcing Russia to seriously consider a peaceful solution. This paper will first consider the effectiveness of Western sanctions against Moscow, in both economic and political terms. It will then consider some of the large obstacles that have prevented the West from strengthening the sanctions. Finally, it will suggest a tentative way forward in this difficult situation.

In the past year the West has imposed economic sanctions on Russia in several stages. In March 2014, as Russia moved to seize the Crimea, initial sanctions cut off talks on economic cooperation and targeted some individuals involved in the Crimea operation. A second round of sanctions in April extended the list of those facing asset seizures and travel bans. And in July, as fighting raged in Eastern Ukraine, a third round of sanctions for the first time affected whole sectors of the Russian economy, targeting financial, defense and energy firms. These sanctions

were embraced not only by the US and EU, but also by Japan, Australia, and several smaller nations.

These sanctions have had a fairly substantial impact on the Russian economy. In the short term, the sanctions helped induce capital flight, with both foreign investors and Russians transferring funds out of the country. It was estimated that about \$150 billion left the country in 2014, a serious burden when one considers that the total value of the Russian economy is about \$2 trillion. New investment essentially stopped. The stock market plunged. By December 2014 the RTS index stood at about 700, a fall of two-thirds from its value in 2011. Inflation has surged; it is currently estimated to be running at 16.4% per year. Even more dramatically, the Russian Ruble seemed near collapse. On December 16 a Euro cost 85.7 Rubles. This had two further negative effects for Russia. First, the government began to run down its hard currency reserves in an attempt to support the Ruble. The government spent almost 40 percent of its liquid reserves from July 2014 to April 2015.¹ And second, in a desperate bid to induce investors to keep money in the country, interest rates were raised sharply, leaping from 10.5 to 17% near the end of 2014. This seemed to have little immediate effect on capital flows, but did further harm struggling Russian businesses. In the few sectors which could potentially benefit from the 'sanctions war' with the West—for example, domestic producers of high quality foodstuffs, which Moscow now refuses to buy from Europe—businesses now find it almost impossible to secure financing. Overall, the economy is clearly in recession. The most recent estimate by the European Bank for Reconstruction and Development is that the country's GNP will fall by 4.5% this year, and at least a further 2% in 2016.² These effects have been sharply increased by the fortuitous timing of a major downturn in global oil prices, Russia's main export. From June 2014 to January 2015 the price fell from about \$110 to \$50 per barrel.

Russia's condition seems to have stabilized in spring 2015—for example, the stock market and the Ruble have crept back up in value somewhat and interest rates were cut to 12.5% at the end of April.³ Most analysts, however, attribute this more to a rebound in the price of oil than to weakness in the sanctions regime. The medium term prognosis remains

poor. For example, the net profit reported by Gazprom fell 86 percent from 2013 to 2014.⁴ Thus it is clear that the sanctions have had an effect, imposing costs on Russia and weakening its ability to project economic power in its own right. These achievements can be important measures of sanctions success.⁵

Yet can the sanctions be considered a success *politically*? This is much more debatable. Supporters of sanctions can claim some results. For example, would President Putin have ever agreed to the Minsk ceasefire accords in September 2014 or the new Minsk agreement this February without Western economic pressure? Also, it is noteworthy that Russia has gone to such lengths to try to hide its involvement in the Donbass fighting. It is clearly concerned about further inflaming world opinion and bringing about even more sanctions. Finally, it is noteworthy what Russia has chosen *not* to do. For example, it has not taken more of Donetsk or Luhansk provinces or the vulnerable city of Mariupol, let alone tried to achieve its maximum goal of conquering all of “Novorossiya” and establishing a land link to Crimea.⁶

However, little progress has been made on the real Western goal—ending the ‘frozen conflict’ in Eastern Ukraine. Russia seems to have succeeded in opening a permanent bleeding wound in Ukraine, like the ongoing conflicts in Moldova and Georgia, which will give it an ability to influence any government in Kiev for many years to come. Furthermore, the conflict in the Donetsk/Luhansk region has succeeded in distracting the world from Russia’s seizure of the Crimea, which has seemingly been relegated to the back burner of world opinion. And President Putin has achieved these results while improving his popularity at home, at least so far. It is often the case that sanctions provoke a ‘rally round the flag’ effect, allowing a leader to exploit his people’s patriotism by appearing to be defending the country from attack. This effect certainly seems to have taken place in Russia, as Putin’s public opinion ratings have risen greatly.⁷

If sanctions are having some effect, but are not yet able to force Russia to change course, strengthening them might seem to be an obvious choice. However, the West faces several large problems in doing so. First, the economic dispute with Moscow has been costly to the West as well as Russia. Exporters have lost business. Germany, Moscow’s leading Western

partner, saw its exports to Russia fall by almost 20% in 2014, with projections of a similar decline in 2015.⁸ Western investors in Russia have suffered. And Russia's counter-sanctions, notably the embargo on imports of food from the West, have had an effect. With its vastly larger economy, the West as a whole does not face great damage from these effects.⁹ However, certain sectors and countries have felt a disproportionate impact. For example, Norway has lost a billion dollars in seafood exports, a rude shock for such a small country. The loss of fruit exports has harmed Greece, especially given its fragile economic condition. It is notable that the new Syriza government in Athens has been tempted to ask Moscow to selectively lift the food embargo. Overall, the Kremlin's choice of food for counter-sanctions was a shrewd one. Agriculture is a politically powerful sector in the EU, and unhappy farmers are often able to persuade European politicians to back their demands.

In short, although the economic pain suffered in the West may be small compared to that inflicted on Russia, it may have more political effect, at least in the short run. Why? Because Western nations are democratic, and thus are more vulnerable to sanctions than an authoritarian regime like that in Moscow.¹⁰ In Russia, the obstacles to overthrowing the Putin regime are large. It would seem that only a huge economic downturn could persuade many to run the risk of openly opposing him. However, in a democracy the barriers to political action are very small. Even a slight economic decline may persuade voters to turn out their leaders.¹¹ The EU is vulnerable on this score, especially because it needs to keep all 28 of its members united to continue the sanctions. And several of these—notably Greece, Hungary, and Slovakia—have already expressed serious doubts.

A second problem for the West is that while some Western states, especially the weaker members of the EU, are vulnerable to Russian economic leverage, Ukraine itself is even more exposed. Its economy is about twelve times smaller than that of Russia. Thus the economic effects of the ongoing war in the Donetsk/Luhansk regions and of direct Russian sanctions on Ukraine have been large. Current EBRD forecasts estimate that its economy will fall by 7.5% in 2015, much larger than the decline seen in Russia. Since Ukraine is a democracy, it may well be that the Poroshenko government cannot maintain popular support for very long. As I showed

in a 2013 paper, Russian sanctions played a role in weakening support for the Orange Revolution government of Victor Yushchenko, helping to lead to its electoral defeat in 2010.¹² Could the same happen to Poroshenko?

Finally, a third problem for the West is that in addition to Western and Ukrainian economic vulnerabilities, Moscow has another card up its sleeve—its ties to China. The sanctions literature has long noted that ‘sanctions-breakers’ can undermine attempts to use economic leverage.¹³ President Xi was seated next to Putin at the military parade on Red Square on May 9. And his role has been more than symbolic. Notably, last year Russia concluded a large deal to sell gas to China. Now the world’s second-largest economy, China can offer a huge market, and also potentially a huge source of investment for Russia. If the West sharpens sanctions too much, it may just drive Putin further into China’s arms.

The question “are the sanctions strong enough?” of course raises another question: “strong enough for what?” It is the contention of this paper that the sanctions are certainly not weak or useless. They do show Western resolve, do impose a serious cost on Russia, and do weaken Russian capabilities. However, are they strong enough to force Russia to withdraw from Ukraine, at least in the short or medium term? No.

What should the West do now? Given the problems noted above, it seems very unlikely that a major strengthening of the sanctions is politically possible, unless Russia takes another highly provocative action. Thus at the moment the major focus should be on maintaining the existing sanctions, particularly as the EU faces a decision this summer on renewing the sanctions into a second year. With patience, the sanctions will continue to bite, which will hopefully lead to concessions from Moscow in the longer term. Also, while Russia is clearly vulnerable to Western sanctions, Ukraine is in an even weaker situation. Thus, economic aid and help in Ukraine’s economic reform efforts are just as important as maintaining sanctions against Moscow.

ENDNOTES

¹ Reserves stood at about \$476.7 billion in July 2014 and \$350.5 billion in April 2015. Source: Bloomberg.com and author's own calculations.

² Larry Elliott, "Russian Recession Will Last Two Years," The Guardian, May 14, 2015.

³ "In Russia, Economic Recovery Remains Elusive," Stratfor Global Intelligence, May 1, 2015.

⁴ Ibid.

⁵ See David Baldwin, Economic Statecraft (Princeton University Press, 1985).

⁶ Iana Dreyer and Nicu Popescu, "Do Sanctions Against Russia Work?" European Union Institute for Security Studies Issue Brief, No. 35 (December 2014).

⁷ The Levada Center reports that 86% of the Russian public approved of Putin in a February 2015 poll (CNN.com, February 26, 2015).

⁸ "German Exports to Russia Could Fall 15% in 2015," Reuters, January 29, 2015.

⁹ Roughly speaking, the economies of the EU and US combined are about 17 times as large as that of Russia, with a GNP of about \$34 trillion compared to Russia's \$2 trillion. Thus any particular volume of lost trade or investment certainly hurts Russia far more than the West.

¹⁰ See for example David Lektzian and Mark Souva, "An Institutional Theory of Sanctions Onset and Success," Journal of Conflict Resolution, Vol. 51 (2007), 848-871.

¹¹ One of the most well-researched theories in Political Science is the economic theory of elections, which shows that when a country's economy declines, the ruling political party will lose votes in a predictable way. Roughly, for every decline of a percent in a country's economy in the year before an election, the incumbent party will lose about 2% of the national vote. See for example Irem Bartool and Gernot Sleg, "Bread and the Attrition of Power: Economic Events and German Election Results." Public Choice, Vol. 141, No. 1-2 (2009), 151-165.

¹² Randall Newnham, "Pipeline Politics: Russian Energy Sanctions and the 2010 Ukrainian Elections." Journal of Eurasian Studies, Vol. 4, No. 2 (July 2013), 115-122.

¹³ For example, sanctions against Iraq before 2003 were greatly weakened by smuggling of Iraqi oil. See for example Lutz Oette, "Decade of Sanctions against Iraq: Never Again! The End of Unlimited Sanctions in the Recent Practice of the UN Security Council." European Journal of International Law, Vol. 13, No. 1 (2002), 93-103.

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