March 2015

Frozen: The politics and economics of sanctions against Russia

By Ian Bond, Christian Odendahl and Jennifer Rankin

CENTRE FOR EUROPEAN REFORM

Frozen: The politics and economics of sanctions against Russia

By Ian Bond, Christian Odendahl and Jennifer Rankin

- ★ Sanctions will remain one of the main Western tools for pressing Moscow to stop intervening in Ukraine. Whether or not the West decides to support Ukraine militarily, sanctions need to be made as effective as possible.
- ★ Too often, sanctions against Russia have followed the logic of 'something must be done; this is something; therefore this must be done'. Future decisions on sanctions should be based on having clear objectives and a solid assessment of their political and economic impact on the EU, Russia and Ukraine. This paper discusses the possible objectives of current and future sanctions, tries to disentangle the real effects of sanctions from the rhetoric used on both sides, and makes recommendations for future Western policy.
- ★ Russia's economy is in a mess, not primarily because of the sanctions, but as a result of a falling oil price, a falling rouble and Russia's own economic policy mistakes. Sanctions reinforce the effects of other problems. The EU economy, though ailing, is a lot more resilient than Russia's.
- ★ If the conflict in Ukraine continues, the West should unite to impose much tougher sanctions on Russia. There should be clear, agreed criteria for Russia to meet before sanctions will be lifted. Top of the list should be restoring Ukrainian control over its border and preventing the flow of Russian arms and personnel into eastern Ukraine. Under the Minsk agreement (if it holds), Russia will only hand back control of the border at the end of 2015.
- ★ Sanctions specifically connected to the annexation of Crimea should remain in place as long as Crimea is occupied.
- ★ The longer sanctions go on without achieving the hoped-for improvement in the situation in Ukraine, the deeper the divisions within the West will become. The more likely it will then be that some EU countries will block renewal of sanctions. Leading EU countries and the US will have to work hard to preserve a consensus.
- ★ The collapse of the Russian economy would not be in the interest of the West. But nor is it in the West's interest for a revanchist Russia to have the power to dominate its neighbours. A prosperous, democratic Russia would be best for everyone; as long as that is unachievable, an aggressive but weak Russia is better than an aggressive and strong Russia. Western leaders should therefore start considering sanctions that would support a policy of containment.

"Truly, the Ukraine crisis is in no way a regional issue. It affects all of us."

Angela Merkel, November 17th 2014

Introduction

It is a year since the regime of Ukrainian President Viktor Yanukovych collapsed and Russian forces began the takeover of Crimea, triggering a first round of Western sanctions. The European Union decided in January 2015 to extend these sanctions until September 2015. Further sanctions, imposed in July 2014 after Russian intervention in eastern Ukraine and the shooting down of flight MH17, will lapse in July 2015 unless they are renewed.

Russia's seizure of Crimea, the first annexation of another European country's territory since World War II, took the Kremlin's relations with the West into uncharted territory. For the West, what is at stake is the post-Cold War order in Europe, and the right of countries to choose their own foreign policy orientation. For the Russian authorities, the further advance of Western organisations into the territory of the former Soviet Union is a threat, and Russia's neighbours have no right to make a choice that has such an impact on Russia's interests.

Since the end of the Cold War, the West's assumption has been that as Russia became more prosperous it would become more like other European countries – that it would see the value of the rule of law, both in its internal affairs and its foreign policy; that making money would become more important than making war; and that it would be a partner in promoting prosperity and democracy throughout Europe.

The reality is that for most of the last two decades Russia has asserted the rule of force over the rule of law, at home as well as abroad; national wealth has been spent on enriching a narrow and unaccountable elite and on rebuilding Russia's military might to threaten its neighbours; and Russia has treated not only its old military rival, NATO, but its would-be strategic partner, the EU, as adversaries. The crisis in Ukraine has highlighted the gap between Russia and the rest of Europe, but the evidence was there before, if European leaders had chosen to see it.

This policy brief aims to provide a factual basis for deciding on the future of sanctions against Russia. It identifies the possible objectives of sanctions and their political effectiveness so far. It analyses the impact of sanctions and other factors on the Russian economy; and the impact of Western sanctions and Russian counter-sanctions on the EU; and it makes recommendations on what else the EU can do, short of military support for Ukraine, to restore international order and stability in its neighbourhood. It also asks whether a prosperous Russia can be a peaceful Russia, or whether only poverty will constrain Russia from foreign adventures; and if so, how much damage the West should be prepared to do to the Russian economy.

Background: Why did the EU impose sanctions on Russia?

When Yanukovych decided in November 2013, after discussions in Sochi with Russian President Vladimir Putin, not to sign an association agreement with the European Union, he triggered a popular uprising against his spectacularly corrupt regime. After a sharp escalation in violence against protesters, the foreign ministers of France, Germany and Poland brokered a deal on February 21st 2014 between Yanukovych and Ukraine's main opposition leaders. This foresaw a government of national unity and a transitional period leading to presidential elections no later than December 2014. Yanukovych, however, fled the country on the night of February 21st, leaving the opposition in control. On February 27th, Russian forces (at first without insignia) began to take over Crimea, an autonomous republic within Ukraine. By March 18th, Russia had annexed Crimea. This sparked the biggest crisis in relations between Russia and the West since the Cold War, and as the crisis deepened, Western governments, led by the European Union and the United States, imposed unprecedented sanctions against President Vladimir Putin's government.

The first wave of sanctions targeted individuals and organisations that had promoted or supported the annexation of Crimea. At the same time, Western leaders ruled out military action to support Ukraine: German Chancellor Angela Merkel told the Bundestag on March 13th 2014 that the conflict could not be resolved by using military means, while US President Barack Obama said on March 20th: "We are not going to be getting into a military excursion in Ukraine". Though support for sending arms to Ukraine has grown in the US, including within Obama's administration, Obama himself and

Merkel have both maintained their opposition to the supply of weapons to Ukraine, even as Russian troops and Russian-backed militias have taken over more Ukrainian territory.

After the annexation of Crimea, trouble spread through parts of eastern Ukraine. Separatist groups (many of them led by citizens of Russia such as the notorious intelligence officer, Igor Girkin, known as Strelkov) took over government buildings and whole towns. As the conflict entered a more violent phase from April 2014, and in particular after the shooting down of flight MH17 on July 17th, the West imposed a second wave of sanctions, including sweeping economy-wide measures that have frozen credit flows and high-tech goods exports to Russia. More than two decades of work to integrate post-Soviet Russia into the world economy came to a sudden juddering halt.

European leaders have stressed that sanctions are a means to an end. The then President of the European Council, Herman Van Rompuy, said in March 2014 "Sanctions are not a question of retaliation; they are a foreign policy tool. Not a goal in themselves, but a means to an end. Our goal is to stop Russian action against Ukraine, to restore Ukraine's sovereignty – and to achieve this we need a negotiated solution". Sanctions can have a number of objectives: (a) to send a political signal of disapproval; (b) to deter further examples of negative behaviour; or (c) to force a state to change its behaviour. The EU seems to want to achieve all three.

So far the EU has clearly not forced Russia to change its behaviour: Russia and its proxies are in control of more Ukrainian territory than was the case in March or July 2014, and are continuing to fight for more. It is hard to prove or disprove the theory that sanctions have deterred Russia from going further still, but the Russian opposition activist Aleksey Navalniy said in an interview with *Le Monde* in January 2015 that "without these sanctions, the Russian army would already be in Odessa". It is at least possible that the sectoral sanctions imposed in the wake of the shooting down of MH17 have led Russia to push forward more cautiously, for fear of provoking another round of even more economically damaging measures, but there is no proof of this. So the only objective which the EU has definitely achieved is to send a signal that it will not ignore the invasion of another European state.

Despite that signal, by the end of January 2015 more than 5,300 people had been killed in eastern Ukraine since fighting started in mid-April 2014, including almost 300 who lost their lives when flight MH17 was shot down over Hrabove. Over 12,000 people had been wounded, while more than a million had fled their homes, either for other parts of Ukraine, for Russia or for third countries. In Donetsk and Luhansk, the main towns in the separatist areas, law and order has broken down, with widespread evidence that volunteer militias are imprisoning, torturing and killing their opponents. In Crimea, minority groups, especially Crimean Tartars, are facing persecution.[1]

War, peace, more war – and more peace?

The signing of a peace agreement between pro-Russian rebels and Ukraine's government in Minsk on September 5th did not end the violence. Hundreds of people have been killed since that ceasefire, while evidence of organised Russian military action in eastern Ukraine continues to accumulate. "Russian armed forces are engaged in direct military operations in Ukraine", NATO concluded in September[2]; there has been no evidence since then that Russia has ended its involvement, and NATO's Supreme Allied Commander Europe, General Philip Breedlove, said on January 22nd 2015 that NATO was again seeing evidence of Russian air defence systems and electronic warfare systems in eastern Ukraine, which had been associated with previous Russian troop movements into Ukraine. Russia continues to deny that it is a party to the conflict, and (according to Russian non-governmental organisations) to conceal the burials of several hundred Russian regular soldiers killed fighting in Ukraine.

"There seems to be little chance that both sides will implement all the terms of the ceasefire."

There was an upsurge in fighting in late January, and Russian or Russian-backed forces expanded the territory under their control. Though another ceasefire was agreed in Minsk on February 12th, fighting around some key points has continued. Under the terms of the agreement, Ukraine will only regain control of its side of the border with Russia at the end of the year, and then only if it has changed its constitution to accommodate the separatists. There seems to be little chance that both sides will implement all the terms of the ceasefire. It is hard, therefore, to see Western sanctions winding down soon; indeed, they may be stepped up.[3] German Chancellor Angela Merkel has said that sanctions cannot be lifted unless "the reasons they were introduced for are removed".[4] But every time

1: Office of the United Nations High Commissioner for Human Rights, 'Report on the human rights situation in Ukraine', December 15th 2014.
2: NATO, 'Joint Statement of the NATO-Ukraine Commission', September 4th 2014.
3: Ian Bond, 'Russia's war in Ukraine: Is Minsk the end, or just the start?', Centre for European Reform, February 13th 2015.
4: 'No lifting of sanctions unless Russia changes tack on Ukraine – Merkel', *Reuters*, January 22nd 2015.

Russia offers the smallest hint of compromise, some Western leaders – instead of maintaining a tough and united stance – urge a new search for compromise and relaxation of sanctions; thus, a paper by the European External Action Service (EEAS) for the Foreign Affairs Council on January 19th set out options for "selective and gradual re-engagement" with Russia, including the possibility of scaling down sanctions in return for implementation of the September 2014 ceasefire agreement. References in the EEAS paper to "trade-offs" between EU and Russian objectives created the impression that the EU's main focus was on an early resumption of dialogue with Russia on issues other than Ukraine. The release of the paper was followed almost immediately by further attacks on Ukrainian frontlines.

The EU has been down this road before: when Russia invaded Georgia in August 2008, and recognised the 'independence' of the separatist enclaves of Abkhazia and South Ossetia, the EU briefly suspended negotiations with Moscow on a new partnership and co-operation agreement, but resumed them in November of the same year. It should not make the mistake of prematurely lifting sanctions again; but nor should it stick at all costs to any of the various measures that are clearly not working or are having counter-productive side effects. Assuming that it still wants to achieve its unattained objectives, it needs to review the sanctions package and ensure that it includes the most effective measures to constrain Russia.

Sanctions: The story so far[5]

★ Asset freezes and visa bans (so-called tier 1 and tier 2 sanctions)
The West's response to Russia's annexation of Crimea was to freeze assets and impose travel bans on pro-Russian Ukrainian rebels and Russian officials, and impose a ban on doing business with organisations, companies or political groups, which were complicit in the illegal takeover. These restrictions came into force on March 17th 2014, initially for six months; they were extended for a further six months in September 2014; and in January 2015 they were extended once more until September 2015. Although the EU and US co-ordinated sanctions, their blacklists are not identical. By November 28th, the EU had imposed sanctions on 132 people and 28 companies or organisations connected with the seizure of Crimea and/or providing support to Russian decision-makers. On December 20th, the EU banned European investment in Crimea, the provision of financial and other services to Crimean companies or for use in Crimea, and port visits to the peninsula by European cruise ships.

★ Economic sanctions (so-called tier 3 sanctions)
Following the shooting down of flight MH17, on July 31st the EU imposed sanctions on the Russian government in four areas: (i) restrictions on lending to Russian state banks; (ii) an arms embargo; (iii) an export ban on oil technology and services that could be used for Arctic or deep-sea drilling, or shale oil projects; (iv) an export ban on dual-use goods – equipment such as specialist computers or heavy engineering vehicles – that could be used for military purposes. These sanctions are due to expire after one year, unless there is consensus to extend them.

★ Russia's food import ban
In response to the EU's July economic sanctions, on August 6th Russia imposed a one-year ban on the import of a long list of agricultural produce from Western countries, including fruit, vegetables, flowers, fish, meat and cheese. Wine, spirits and dry goods (pasta) were not included; exemptions were made for baby food.

Economic ties between Russia and the European Union

The EU has more at stake in its economic relationship with Russia than any other Western actor that has imposed sanctions on Russia. A number of European countries are entirely or almost entirely dependent on Russia for gas supplies. Overall, the EU gets around one third of its oil and gas from its eastern neighbour, and does 12 times more trade with Russia than the United States does.[6] In responding to Western sanctions Russia has therefore tried to encourage the idea in Europe that measures are being imposed at the behest of and for the benefit of America, and against the interests of Europeans.[7]

Trade ties between Russia and the EU may run deep, but the relationship is unequal. The EU is a far more

5: A comprehensive list of EU, US and other Western sanctions against Russia is contained in Jarosław Ćwiek-Karpowicz and Stanislav Secrieru (editors), 'Sanctions and Russia', PISM, January 2015.

6: European Commission, 'In-depth study of energy security', July 2014; European Commission DG Trade, 'European Union, trade with Russia', August 27th 2014; European Commission, 'Russia, trade with the world', August 27th 2014.

7: See, for example, Sergei Lavrov's interview with *France 24*, December 16th 2014.

important trading partner for Russia than the other way round. Based on total trade (exports and imports), the EU is roughly five times more important to Russia than vice versa. The EU buys more than half of Russian exports, equivalent to almost 10 per cent of Russia's economic output (see Chart 1). Russia's second largest trading partner, China, is far behind, accounting for just 7 per cent of Russia's exports. In contrast, Russia is only the EU's fourth largest export market, behind the United States, Switzerland and China; Russia makes up 7 per cent of EU exports, less than 1 per cent of the bloc's GDP (see Chart 2).

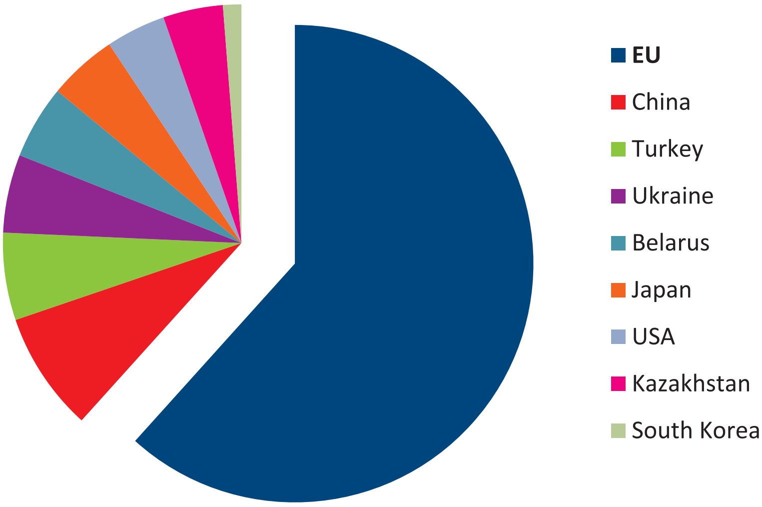

Chart 1: Russia's top export markets in 2013

Source: Eurostat

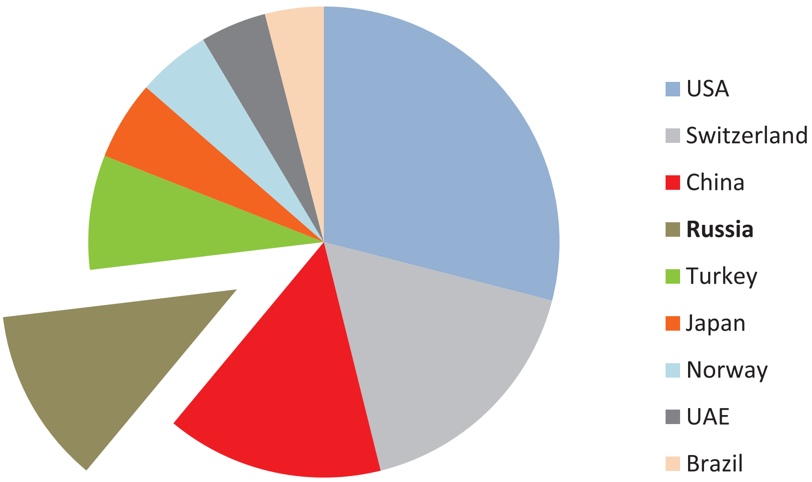

Chart 2: The EU's top export markets in 2013

Source: Eurostat

The EU also has a much larger economy than Russia. In 2013, Russia's economy ($2.1 trillion) was roughly the size of Italy's ($2.15 trillion), and considerably smaller than Germany's ($3.73 trillion). After the devaluation (from 32 roubles per dollar in 2013 to 61 at the end of February 2015), Russia's economy is just $1.1 trillion – somewhat larger than the economy of the Netherlands ($0.85 trillion) but smaller than that of Spain ($1.4 trillion).[8]

The perfect storm of sanctions, a falling oil price and a tumbling currency has now increased the economic pressure on Russia beyond what Western policy-makers could have imagined when imposing the sanctions. The EU economy, on the other hand, has proven resilient – it has not deteriorated but instead grown slowly. One reason is that European policy-makers have finally come around to supporting economic demand via looser monetary policy ('quantitative easing') and less onerous spending cuts, while the falling oil price acts as a further stimulus. The other reason is that Russia is not very important for the EU economy. In what follows, we analyse the economics and politics of sanctions both in Russia and the EU.

8: Those are back-of-the-envelope calculations. Adjusting an economy by the international exchange rate does not take into account that prices for Russian domestic goods like a haircut are much cheaper. GDP data based on so-called purchasing power parity (PPP) exchange rates is only updated with a significant delay and is not without its problems.

The cost of sanctions for Russia

If sanctions are to have some effect on Russian policy-making, they need to have a cost for Russia – for its economy, military or leadership. In his annual address to the Russian parliament on December 4th 2014, Putin, recognising the costs, described the sanctions as an excuse to "try to contain Russia's growth capabilities". But he also claimed that the sanctions would be "an incentive for a more efficient and faster movement" towards his reform goals, including freeing Russia from dependence on foreign technology. Putin set targets of achieving growth rates above the global average within three to four years, and a cut in inflation to 4 per cent.

The problems of the Russian economy are huge, even without the effect of sanctions and falling oil prices. Russia is an emerging economy heavily reliant on oil and gas, with an urgent need of modernisation to lift more than 15 million people out of poverty.[9] The economic model followed by Putin since he came to power in 2000 is broken.

Putin's first decade in power was underpinned by rising oil prices, which allowed a rent-seeking elite to earn fortunes from Russia's mineral wealth. As a result of the resource boom, the rouble's real effective exchange rate (which takes Russia's high inflation into account) rose strongly from 1999 to 2008. This made non-resource export industries uncompetitive – a common phenomenon of resource-rich countries called 'Dutch disease' (see Chart 3).

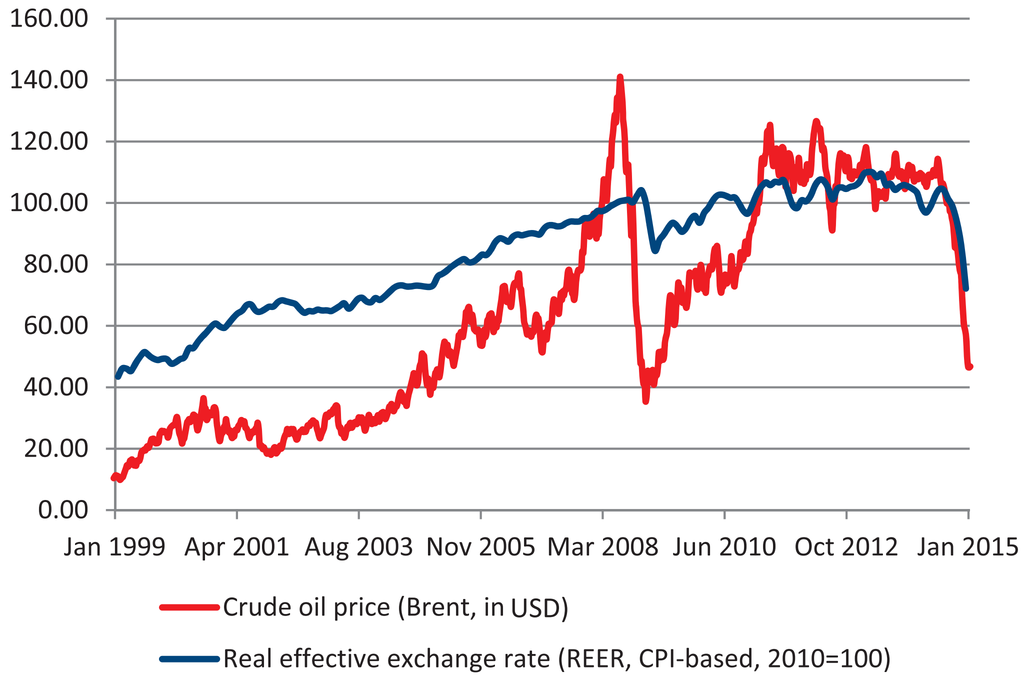

Chart 3:
The oil price and Russia's exchange rate

Source:
Federal Reserve Economic Data (FRED)

Notes:
A nominal effective exchange rate weighs all the exchange rates of the rouble with other currencies by the share of Russian trade with these countries. The REER adjust these exchange rates for the difference in inflation between pairs of countries.

Ordinary Russians also saw their incomes grow, but the rule of law weakened and corruption flourished: Russia ranked 136th out of 172 countries surveyed by Transparency International in 2014. Long before the hammer blows of sanctions, falling oil prices and a collapsing currency, the Russian economy was stagnating. The modernisation plans launched by Dmitri Medvedev during his 2008-12 presidency were a recognition among the elite that change was needed. But because of the absence of meaningful political reforms during his tenure, and the crackdown on civil society following Putin's return to the presidency, modernisation never became more than a slogan.

From stagnation to crisis

Now Russia is in recession. In January 2015, confidence indicators in the service and manufacturing sectors dropped to new five-year lows, pointing to a large contraction in activity.[10] The International Monetary Fund (IMF) predicts a contraction of 3 per cent of GDP in 2015, but it could be much worse: market consensus according to Reuters projects a 4.2 per cent decline in 2015, and the European Bank of Reconstruction and Development (EBRD) forecasts a fall of "close to 5 per cent".

9: The World Bank, 'World Development Indicators', February 22nd 2015.

10: HSBC, 'Purchasing Managers' Index', February 2nd and 4th 2015.

The two main reasons for the recession are the fall in the oil price and the decline in the value of the rouble (see Chart 3), which are closely connected and interact with Western sanctions to the disadvantage of the Russian economy. Lower oil revenues (in US dollars) mean less demand for the Russian currency. In addition, the loss of confidence in the Russian economy, combined with financial sanctions and political uncertainty, has led to capital flight as wealthy Russians and foreign investors dump rouble assets. That is not only leading to a collapse in investment, which further weakens the economy, but also exacerbating the fall in the currency. Overall, $151.5 billion of private capital left Russia in 2014. To put that figure into perspective, foreigners held direct and portfolio investments in Russia in the order of $477 billion and $225 billion respectively (at the end of September 2014).

The Russian central bank has intervened heavily to defend the rouble (see Chart 4). At the end of January 2015, Russia had $376 billion in reserves, down from $499 billion a year earlier. Nearly half of the remaining reserves, however, are not under the full control of the central bank. Two sovereign wealth funds, the Reserve Fund (current foreign and domestic assets of roughly $88 billion) and the National Wealth Fund of the Russian Federation ($78 billion, down from $89 billion a year ago), hold large reserves and are under the control of the Kremlin.

> *"Loss of confidence in the Russian economy, sanctions and political uncertainty have led to capital flight."*

In recent weeks, the oil price, and as a result the rouble, have stabilised and somewhat recovered from their lows. But the risk of a further fall in the rouble is still large. If investors expect that currency reserves will run out and that the central bank will have to impose strict capital controls to stop outflows, investors and Russians might opt to reduce their exposure to rouble assets quickly. And any capital controls would be a major obstacle to foreign investment in Russia.

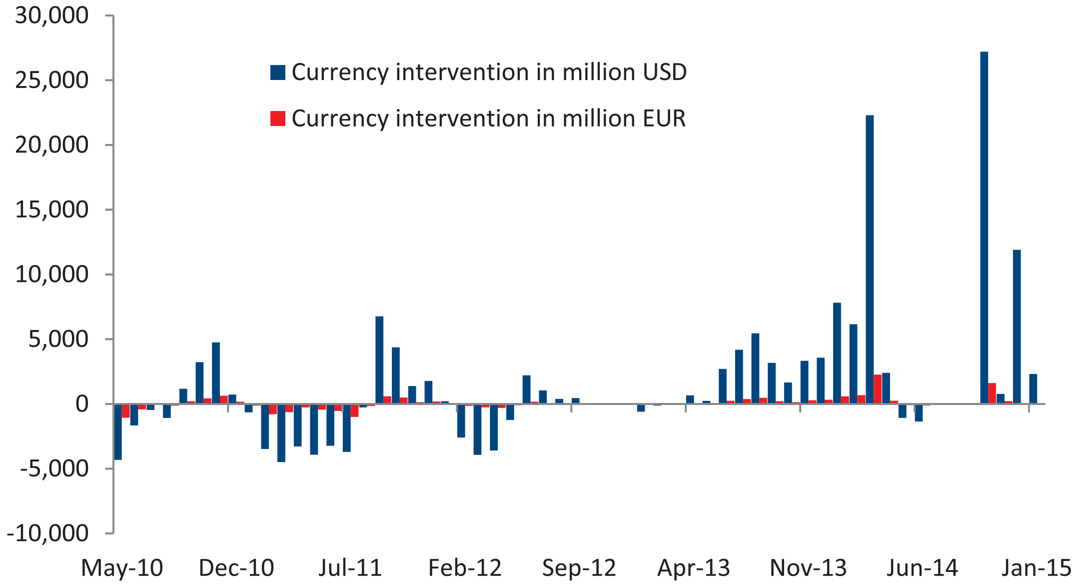

Chart 4: Currency interventions by the Russian central bank

Source: Bank of Russia

One negative impact of a falling rouble is inflation. Food prices in particular have risen dramatically in recent months, in part because of Russian counter-sanctions on food imports, which were imposed on August 6th 2014 (see Chart 5). Such imported inflation lowers the real incomes of households; as a consequence, they are spending less on Russian goods, hurting the economy.

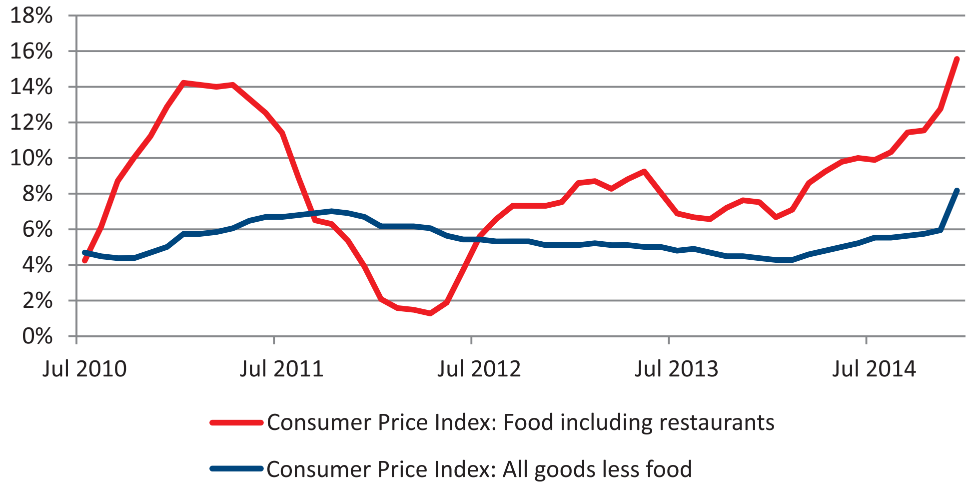

Chart 5: Inflation in Russia

Source: Federal Reserve Economic Data (FRED)

Another negative effect of a falling rouble is high interest rates. In an attempt to stabilise the currency in mid-December, the Bank of Russia raised its key rate to 17 per cent. With non-food inflation at 9 per cent, that means that real interest rates are prohibitively high at around 8 per cent, which is depressing consumption and investment. This is a classic dilemma of emerging markets in crisis: the central bank is trapped between having to stabilise the currency by means of higher interest rates, and trying to help the wider economy, which would benefit from lower rates. The central bank cut interest rates to 15 per cent in late January and to 14 per cent in mid-March, but this will only marginally lower the negative impact on the domestic economy.

The final problem of a falling rouble is that it causes the value of debt in foreign currency to balloon. The current external debt of banks and firms stands at $600 billion. It has fallen by $130 billion over the past six months, as international investors were unwilling to roll over maturing debt. But calculated in roubles, the foreign debt increased from 24.9 trillion to 33.8 trillion over that period. In 2015, these banks and firms have to repay $110 billion, and another $53 billion in the first nine months of 2016 (see Chart 6). Russia's current account surplus, from which that external debt could be repaid, is just below $60 billion a year – and bound to fall because of the decline in the oil price. This means that Russia will need to run down foreign currency assets in 2015 to cover the difference.

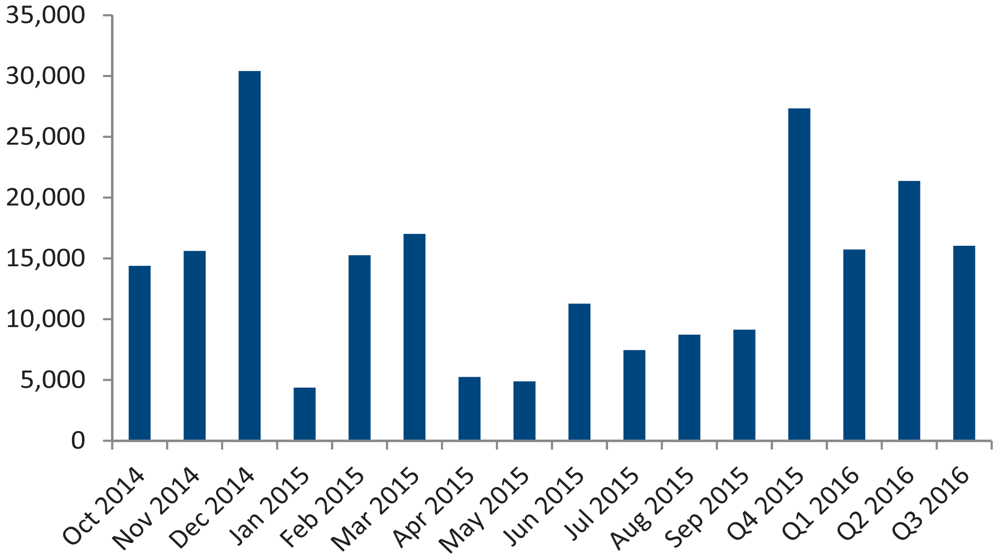

Chart 6: Repayment schedule of Russian external debt

Source: Bank of Russia

Note: Data for late 2015 and 2016 is quarterly.

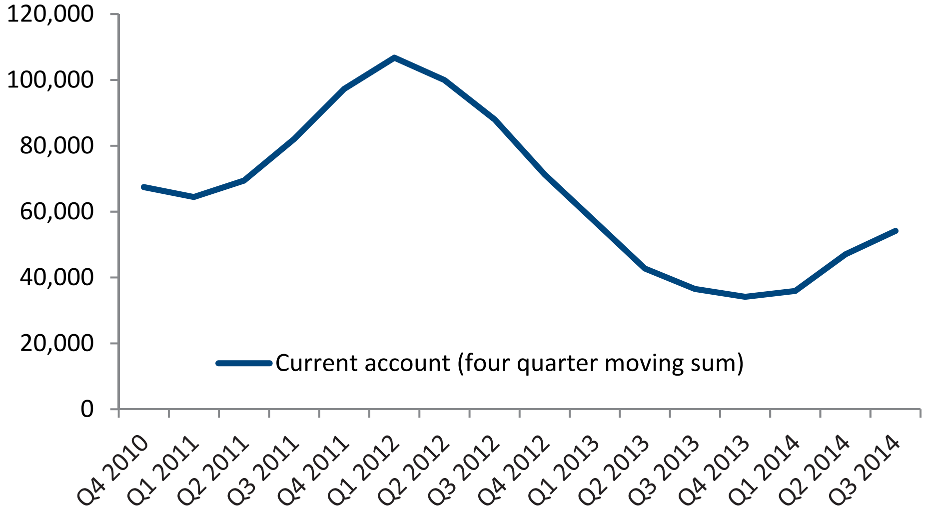

Chart 7: Russia's current account surplus

Source: Bank of Russia

There could be one silver lining: a weaker currency benefits exporters. But business surveys find that manufacturers have suffered from declining export orders for 17 months in a row – and the fall in the rouble would have been expected to boost exports. One reason is that Russian manufacturers often supply investment goods to the global energy sector, which is suffering from falling energy prices. Another reason is years of under-investment in other sectors of the economy.

Falling oil prices have hit the state budget hard. Although President Putin has said lower oil prices are not "a tragedy", Russia relies on fossil fuel revenues to finance half its budget.[11] Russia's 2015 budget was originally based on oil prices of $100 a barrel, but the government currently expects an average price of just $50, which is reasonable, given average market forecasts of around $55 for 2015.

Military spending is protected and even planned to increase. Alexei Kudrin, Russia's former finance minister and now a moderate critic of the Kremlin's economic policy, believes that the military modernisation programme, which has seen the defence budget quadruple since Putin first became president in 2000 to $81 billion (at pre-crash exchange rates) or 4.2 per cent of GDP, is unaffordable. Putin disagrees: he forced the finance minister, Anton Siluanov, who had previously warned that defence spending would have to be cut, to tell the Russian parliament on January 14th that the defence budget would get its scheduled increase of about 20 per cent.

Since military spending is forecast to increase, the government must make big cuts elsewhere. Such fiscal retrenchment will further depress economic activity. The Russian government will struggle to borrow from abroad: one of the three main rating agencies, Standard & Poor's, has already downgraded Russian government bonds to non-investment grade status (also known as 'junk'), and the ratings of the other two, Moody's and Fitch, are just a whisker above this threshold.

How sanctions interact with the falling oil price and the falling rouble

The sanctions themselves contribute indirectly to the capital flight and loss of confidence in the Russian economy. But there are more direct impacts on two sectors of the economy in particular: on the financial industry and on the energy sector.

EU and US sanctions have cut off some Russian banks and companies from direct access to western financing. Some key companies and banks now need to turn to the central bank and the government for funding, putting further strain on Russia's foreign exchange reserves. But Western finance is also hard to tap for those firms and banks that are not among the sanctioned, as Western banks are afraid to fund them, fearing that Russia's deteriorating economic situation or potential further sanctions will lead to future losses. Even if sanctions are eventually lifted, fear of a repeat scenario could impair Russia's access to international capital markets for years to come.

The downgrade of government bonds also has knock-on effects for banks and firms in Russia, as a weaker sovereign rating usually leads to lower ratings for banks and firms as well. This further impairs their access to funding. Fitch, for example, downgraded 13 firms in mid-January, following the downgrade of the Russian government.

11: 'Putin says current oil price no tragedy for Russia's budget', *Reuters*, October 17th 2014.

A time-honoured tool of autocratic governments is to provide loans selectively to companies close to those in power via state-owned or state-controlled banks. This works best if businesses have limited access to international funding. But some companies will not enjoy such preferential access. Furthermore, the strained funding of domestic banks will induce them to tighten lending conditions for companies and households. The most recent bank survey shows that credit standards tightened considerably across the board in the third quarter of 2014, and they will have tightened further since then (see Chart 8).

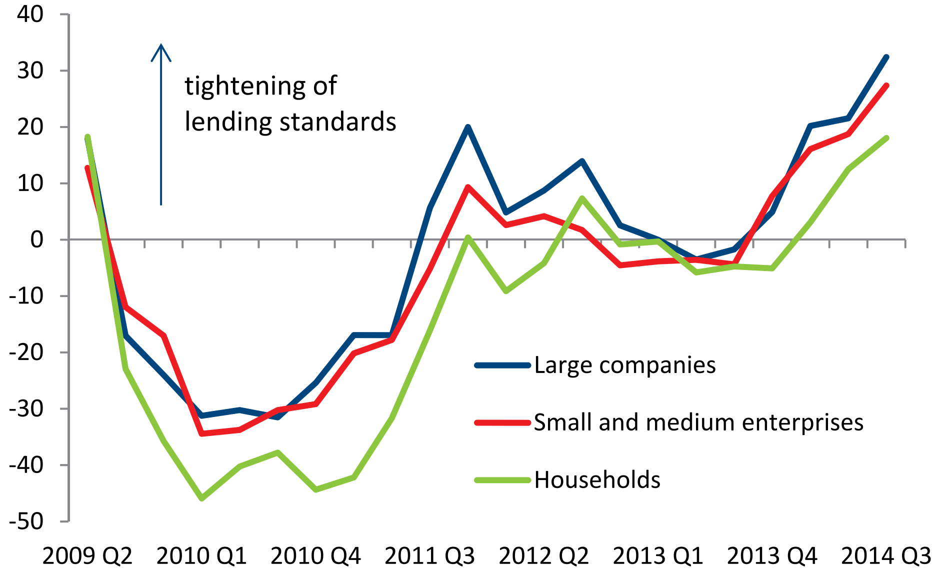

Chart 8: Bank lending conditions for Russian firms and households

Source: Bank of Russia

Note: The chart shows the balance of answers of banks to the question of whether they have loosened or tightened credit standards.

A potentially devastating sanction, not yet deployed by the West, would be to ban Russian banks from using SWIFT, the international payment system based in Brussels. SWIFT, the 'plumbing of the international financial system', has a de facto monopoly on simple and secure international money transfers. The knock-on effects on Russia's financial system and international trade are potentially large, especially in the short run when no alternatives exist, and would mean costlier and less secure procedures. However, the likelihood of a SWIFT competitor emerging over time, potentially involving China, should also be taken into account. A SWIFT ban would therefore be among the sanctions of last resort, comparable to a ban on imports of oil and gas from Russia.

The energy business is also directly affected by sanctions that restrict access to crucial technology for deep sea drilling and shale oil extraction. First, sanctions are likely to delay the modernisation of Russia's oil industry. Several Western companies have pulled out of ventures with Russian partners. Exxon Mobil has been forced to suspend all ten of its joint ventures with Rosneft, most notably its search for oil in the Kara Sea in the Arctic Ocean. France's Total has suspended a joint venture with Lukoil to explore for shale oil in western Siberia; and Shell has abandoned a joint venture with Gazpromneft to develop shale oil. Norway's Statoil has said it expects delays in some (but not all) of its joint projects with Russia.

As Western companies retreat, Russia is left with the task of modernising its oil industry in order to reduce dependence on ageing fields in western Siberia, where output is declining. Around 90 per cent of Russian oil comes from fields discovered before 1988 and the government needs to commission three or four large fields each year simply to arrest the decline in oil output, according to Lukoil, Russia's largest private oil company.[12]

Western energy sanctions are a major setback for these plans. IHS CERA, an oil consultancy, has forecast that, if Western sanctions are maintained, Russian production could fall from a current level of roughly 10.5 million barrels a day to around 7.6 million barrels a day by 2025.[13] Already in 2015, oil production will average 0.14 million barrels a day less than in 2014, according to the International Energy Agency (IEA).[14] Sanctions may also hinder the development of unconventional fields like the Bazhenov shale fields in eastern Siberia, widely believed to contain the world's largest reserves of shale oil. So far, Russian fracking is negligible compared to US and Canadian projects.

The Russian government argues that the participation of Western oil majors is not essential. "We will do it on our own," Igor Sechin, the president of Rosneft, told journalists in October.[15] Hopes for the 'Russification' of the oil industry are exemplified by the creation of a state research and technology company that will focus on

12: Lukoil, 'Global trends in oil and gas markets to 2025', June 24th 2013.
13: 'Russian oil: Between a rock and a hard place', *Financial Times*, October 29th 2014.
14: International Energy Agency, 'Oil market report', January 16th 2015.
15: 'The Russification of oil exploration', *The New York Times*, October 29th 2014.

producing machine tools, engineering and specialist drilling equipment. However, such modernisation projects require investment, just as Russian banks and companies are struggling to raise finance to pay for their existing operations. Russia may need to spend around $100bn to develop a shale oil industry comparable to the United States, according to Lukoil. It is hard to see how the government can avert a decline in oil output and stop new projects slipping further into the future.

The effect of sanctions on Russian politics

Both Western and Russian opponents of sanctions argue that the measures have consolidated support for Putin: First Deputy Prime Minister Igor Shuvalov said at the World Economic Forum in Davos that Russians would never give up their leader: "We will tighten our belt, eat less food, suffer any privations". Putin's sky-high approval ratings, which soared to 86 per cent following the annexation of Crimea, buttress his argument. Western leaders must face the uncomfortable fact that for now sanctions are failing to shake Vladimir Putin's position in the Kremlin. Alexey Grazhdankin, deputy director of the Levada Centre (an independent polling organisation), argues that Russians see the current conflict with the West through the prism of the Second World War, or the 'Great Patriotic War' as Russians call it. Russian leaders are increasingly drawing on Soviet myths about the war to bind society together. "The division between 'those who are with us' and 'those who are against us' stretches into the current time", Grazhdankin said in a recent interview with Deutsche Welle. A recent editorial in *Vedomosti* also looked at these resonances. Support for belt-tightening following the import ban was an "inadvertent effect of the cult of victory of the Great Patriotic War", its leader writer stated.[16]

On the other hand, there are a few signs of dissent within the Russian elite, which may indicate that at least some members of it understand the damage that current policies are doing, both to their personal interests and to Russia's economic prospects and international standing. German Gref, a former minister under Putin and now president of the (sanctioned) Russian bank Sberbank, has indicated that sanctions are having a major effect on the bank's ability to borrow money; at an investment conference in Russia in October he was also openly critical of current economic policies, reminding the audience that Soviet leaders' ignorance of the laws of economic development eventually caught up with them. In October the minister for economic development, Aleksey Ulyukaev, openly criticised a draft law introduced by the ruling 'United Russia' party that would direct the state budget to compensate Russians whose assets overseas were frozen through sanctions (despite this, the bill passed and was signed into law by Putin). Anton Siluanov, the finance minister, warned in September that sanctions and counter-sanctions would further reduce investment in Russia, and urged a reduction in the defence budget – until he was brought back into line.

The problem for the West is that so far these technocratic figures, many of them seen as closer to Prime Minister Dmitri Medvedev than to Putin, do not seem to be having much influence. Instead, statist and nationalist officials, often from the security services, appear to have convinced Putin that Russia can go it alone, and that the price the West is prepared to exact for Russia's actions in Ukraine is low enough to make the annexation of Crimea and invasion of eastern Ukraine worthwhile.

> *"Russian popular opinion has been slow to make the connection between rising food prices and Putin's policies."*

Russian popular opinion, fed on a diet of anti-Western propaganda, has been slow to make the connection between rising food prices and Putin's policies. In a poll by the Levada Centre in mid-November, which allowed respondents to name more than one cause of Russia's economic problems, almost half the people blamed falling oil prices; a third blamed Western sanctions; almost as many blamed the cost of the annexation of Crimea; and a quarter blamed it on governmental corruption and lack of reform.[17] The Russian public has not so far focused on the use of the National Welfare Fund (meant to support pensions) to bail out state companies or pro-Kremlin oligarchs whose finances have been affected by sanctions.

Of course opinion polls in an authoritarian state, where independent media are heavily constrained, cannot be entirely trusted. The question is whether discontent, or confidence to express discontent, will grow as people realise that the state is in fact compensating elite 'victims' at the expense of the rest of society, and leaving Russia's soldiers to be buried in secret, casualties of a war that the Russian government dare not admit it is fighting.

16: 'The heroism of deprivation', *Vedomosti*, August 29th 2014.

17: Peter Hobson, 'Russians divided on whether to blame sanctions, oil or Crimea for economic hardship', *The Moscow Times*, November 28th 2014.

The cost of sanctions for the EU

The European Commission estimated that altogether, sanctions will knock 0.3 percentage points off the EU's economic growth in 2014, and 0.4 per cent in 2015, according to an unpublished document leaked to the media in mid-2014. Most of the effect of sanctions will come from lower demand for European goods and services and from Russia's counter-sanctions on European food products. The asset freezes as well as visa bans on 132 people, some of whom may have significant assets in the West, are unlikely to have a noticeable effect. Should Russia contemplate further measures, the key risks for the EU economy would be disruption of the energy supply, and the knock-on effects on financial stability in Europe.

European manufacturing firms are mostly feeling the indirect effects of sanctions via lower demand from Russia for EU exports. Germany has the most to lose: it accounts for one third of EU exports to Russia and 6,200 German companies have a presence in the country (see Table 1). The morale of German businesses and investors overall – as measured by the ZEW and the Ifo indicators of economic sentiment, two widely followed business surveys – slumped in October, which analysts blamed in part on sanctions and wider geopolitical risks.[18] The Committee on Eastern European Relations, an organisation of German employers active in Eastern Europe which has lobbied against sanctions, has argued that sanctions will cost Germany €7 billion of lost exports in 2014 and put "at least" 50,000 jobs at risk.[19]

TABLE 1: EU goods exports to Russia in 2012

Source: Eurostat

EU 27	€123bn
Germany	€38bn
Italy	€10bn
France	€9bn
Netherlands	€8.4bn
Poland	€7.7bn

However, such numbers must be taken with a pinch of salt. First, there is little evidence of job losses resulting directly from sanctions. If companies are struggling or have spare capacity, German labour market policies allow for *Kurzarbeit* (shorter working hours), to preserve jobs, albeit at slightly lower wages and some costs to the German taxpayer.

Moreover, not all German businesses expected a serious decline in Russian business. A poll by the German-Russian Foreign Chamber of Commerce from August 2014 found that two-thirds believed that business with Russia would improve or remain unchanged.[20] A more recent survey shows that expectations have deteriorated massively, with 91 per cent predicting a worse 2015, but the timing suggests that the fall in the oil price and the rouble are the cause, rather than sanctions.

> *"Despite the weakening Russian economy, German business confidence has risen strongly since October."*

Second, such gross job-loss calculations do not take into account policies that could avert a slump. Policy-makers, whether the German government or the European Central Bank (ECB), are likely to react to a slowing economy by resorting to monetary stimulus and more public spending. This would, albeit with a lag, create jobs and growth elsewhere in the economy, compensating in part for the potential decline of industries exposed to Russia. The European Commission's recent €315 billion investment plan (the 'Juncker plan') and the recent announcement of quantitative easing by the ECB can be seen in this light. The falling oil price is a further stimulus as it increases the real incomes of consumers.

Third, the disruption to the German economy needs to be put in perspective. Russia is Germany's 11th largest export market, behind the US, China, the UK, Switzerland and several eurozone partners. An uptick in economic activity in any of these markets would compensate for the fall in exports to Russia. And indeed, despite the recent worsening of tensions with Russia and the drastic weakening of the Russian economy, the ZEW and Ifo indices have risen strongly since October.

Fourth, and finally, Russia's economy was weakening well before economy-wide sanctions were implemented. In the first four months of 2014, German exports to Russia fell by nearly 16 per cent, compared with the previous year. Even countries that have not imposed economic restrictions on Russia have lost out. Turkey's exports to Russia were down 13 per cent in 2014 on the previous year, defying analysts' predictions that the country would be a winner from the economic disruption.[21] The fall in exports to Russia is more likely to be related to the general weakening of the Russian economy than to sanctions.

18: The Mannheim-based Centre for European Economic Research, better known as ZEW, and the Munich-based Institute for Economic Research, better known as the Ifo Institute, conduct monthly polls of German investors and businesses about the economic climate and their expectations for the future.

19: Personal communication from the Committee on Eastern European Relations, September 15th 2014.

20: The German Russian Foreign Chamber of Commerce, 'VTP Survey, German business states its position in complex circumstances', September 11th 2014.

21: Turkish Statistical Institute, 'Foreign trade by top twenty countries, 2013-14', November 28th 2014. Data compares January-October 2014 with the same period in 2013.

Chart 9: German exports to Russia

Source: Federal Statistical Office, Germany

The EU sells a lot more butter than guns to Russia, so the cost of the military export ban will be small. EU countries, mostly France and Germany, sold weapons and military equipment worth €193 million to Russia in 2012. But EU countries have in the past supplied Russia with systems or components that have improved the performance of Russian weapons. The French firm Thales has had a contract since 2007 to deliver 331 infrared gun sights for Russian tanks, with the Russians planning to manufacture more under licence. It is not clear how many sights have been supplied, or at what price, or whether the Russians can now manufacture them without French imports, but some of the Russian tanks spotted in Donetsk and Luhansk have been fitted with these sights. They give the Russians an edge not only over Ukrainian tanks but also over (for instance) Polish tanks.

Germany's Rheinmetall signed a contract in 2012 worth more than €100 million to provide a high-tech combat training centre for the Russian army.[22] The facility was supposed to enable 1000 'players' to conduct simulated battles in urban terrain, and would have been "the most advanced system of its kind in the world" according to a Rheinmetall executive. The German government blocked the export in 2014 as a result of EU sanctions, with a significant financial impact on Rheinmetall.

The biggest 'casualty' of the ban on military exports is France's €1.2 billion contract to supply Russia with two *Mistral* amphibious assault ships. According to French officials, quoted by the BBC, cancelling the contract would cost France "at least €1 billion", because the government would have to repay the money it has already received from Russia, plus a penalty for breach of contract.

Although France managed to persuade other EU leaders to exempt the *Mistral* ships from sanctions, it may have feared that delivering the first helicopter carrier would damage its prospects of selling defence equipment to EU partners. This was not an unreasonable calculation: Polish defence minister Tomasz Siemoniak told the newspaper *Rzeczpospolita* on September 29th: "I can't hide the fact that the *Mistral* issue is not helping us make positive decisions" about a French bid to supply air defence missiles to Poland. On November 25th, President François Hollande suspended delivery of the first ship "until further notice" because of the situation in eastern Ukraine.

EU exports of services (legal, financial and business services) make up less than a quarter of total exports to Russia by value. Contrary to widespread perception, the UK is not a big loser. For instance, France's foreign minister, Laurent Fabius, warned the British government in the early stages of the crisis that it should look to its financial sector, before voicing an opinion on the sale of the *Mistrals* to Russia. Yet the UK sells only slightly more services to Russia than France and much less than Germany (see Table 2). Despite the political focus on the City of London, the UK's financial service exports to Russia are not significant: in 2013 just 1 per cent of the UK's total £118 billion exports in financial services went to Russia.[23]

EU 28	€29.3bn
Germany	€6.6bn
UK	€2.4bn
France	€2.09bn
Finland	€2.07bn
Spain	€1.7bn
Italy	€1.7bn

TABLE 2: EU services exports to Russia in 2012

Source: Eurostat

22: Nicholas Fiorenza, 'Rheinmetall works on combat training center in Russia', *Aviation Week & Space Technology* – Defense Technology Edition, September 3rd 2012.

23: Office for National Statistics, 'United Kingdom balance of payments, the Pink Book 2013,' July 31st 2013.

Russian retaliation: Agriculture

European farmers and fishing crews are the most obvious losers from EU sanctions, following the Kremlin's import ban on fruit, vegetables, meat, dairy, fish and other foodstuffs. By far the worst affected country is Lithuania (see Table 3): food exports affected by the ban account for 2.6% of its economic output. But the overall cost is low: the goods affected by Russia's import ban amount to just 0.03% of the EU's economic output. The Commission has released emergency funds from the Common Agricultural Policy budget to help farmers bear the costs. The amount, totalling €318 million by mid-November, is small compared to the value of the affected products, but reflects the Commission's view that many producers will have found alternative markets.

TABLE 3: Value banned agri-food produce to Russia in 2013

Source: European Commission, Eurostat

	Value of banned products	Share of GDP (in per cent)
EU28	€5bn	0.03
Lithuania	€922m	2.6
Poland	€840m	0.2
Germany	€589m	0.02
Netherlands	€503m	0.08
Denmark	€341m	0.1

Indeed, there is some evidence that European producers have found new markets on Russia's doorstep. Russia's food safety watchdog has detected attempts to circumvent the ban by sending goods to Belarus to be re-labelled and re-exported into the Russian market. The nature of this activity makes it impossible to get precise figures, but the latest EU-Belarus trade figures suggest that 'Parmigiano-Belarussiano' is not just a Moscow joke.[24]

"Food price inflation and Russian counter-sanctions hurt the Russian consumer much more than the European producer."

The Russian counter-sanctions are also part of the government's attempt to make Russia self-sufficient in food in as little as three years. Russia imported around 40 per cent of its food in 2013. According to Russia's dairy producers, they would need $16.7 billion in investment from 2014-2020 to meet 90 per cent of Russia's dairy needs (up from 78 per cent currently), which given the funding constraints of the Russian economy is unlikely to happen. Together with the fall in the rouble and the resulting food price inflation, the Russian counter-sanctions hurt the Russian consumer much more than the European producer.

Russian retaliation: Gas supplies

The security of Europe's gas supplies has been a concern throughout the West's stand-off with Russia. A total of eight member-states are 100 per cent dependent on Russian gas. And four of the eight are also wholly reliant on Russia for the supply and processing of nuclear fuel. In 2014, despite tensions with Russia, Hungary and Finland agreed deals with Rosatom to build nuclear reactors. The EU also gets 34 per cent of its oil from Russia, although the relative ease of switching oil suppliers means that disruption of the oil supply should pose less of a problem than any reduction or cut-off of the gas supply.

EU countries 100 per cent dependent on Russian gas	Share of gas as percentage of total energy consumption
Bulgaria	14
Czech Republic	18
Estonia	10
Finland	10
Latvia	30
Lithuania	36
Hungary (98 per cent)	35
Slovakia	28

TABLE 4: Share of gas energy mix of most dependent countries

Source: Eurostat, European Commission

24: Following the entry into force of the Russian export ban on August 6th, EU customs officials found "considerable increases" in exports of EU beef, poultry, dairy products, fruit and vegetables to Belarus on the previous year, a trend that continued through the autumn according to unpublished information provided by the European Commission. Norway has seen a similar effect: exports of salmon to Belarus rose by 167 per cent in the eight weeks after Russia imposed sanctions, compared with the previous year.

TABLE 5: Share of nuclear power in energy mix of most dependent countries

Source: Eurostat, European Commission

EU countries 100 per cent dependent on Russian nuclear fuel	Share of nuclear energy as a percentage of total energy consumption
Bulgaria	11
Czech Republic	16
Hungary	16
Slovakia	21

Russia, Ukraine and the EU reached a deal in October 2014 to keep gas supplies flowing to Ukraine and through the pipelines across it to Central Europe until March 2015, but the agreement is widely seen as a temporary fix, and at the end of February Russia once again threatened to cut supplies to Ukraine over alleged payment arrears. The EU's decision not to include gas technology in its energy sanctions probably reflects its aim of giving Gazprom no reason to declare its European contracts null and void, and therefore stop supplies.

On the other hand, not all Russian gas reaches Europe via Ukraine, and Russia has (so far) not threatened to cut off other routes; this is consistent with its efforts to show that the gas dispute with Ukraine is commercial, not political. What it is trying to do, however, is to create alternative pipeline routes bypassing Ukraine, thereby increasing its leverage with Kyiv. The planned 'South Stream' pipeline project, which would have gone across the Black Sea to Bulgaria, and thence via Serbia and Hungary to Austria, would have achieved this. The Commission tried to block the project on competition grounds; Putin ultimately announced during a visit to Ankara in December 2014 that he was cancelling it, and that Russia would instead build a pipeline across the Black Sea to Turkey.

Europe's energy dependence is also not always as black and white as it seems. Estonia and Finland are both 100 per cent dependent on Russia for gas, but gas makes up only 10 per cent of their total energy supply. Hungary, on the other hand, which gets more than half its energy from Russia (gas and nuclear), is considerably more exposed.

The EU is slowly weaning itself off Russian gas: when Moscow stopped gas supplies in 2009, Russia supplied 40 per cent of EU gas and 18 EU member-states were seriously affected by shortages. While Russia now supplies less than one third of the EU's gas, eight member-states (and three EU candidate countries in the Balkans) would have faced serious problems during this winter had Russia disrupted supplies, according to the European Commission. In the event of a six-month stoppage of Russian gas supplies to Europe, Bulgaria, Romania, Finland and the Baltic states would lose anywhere between 40-100 per cent of the gas they need. Stockpiled supplies would only partly fill the gap.

These problems could be substantially mitigated by timely collective action. EU member-states should respond to future shortages by building pipeline connections across Europe and enabling pipelines to pump gas in both directions. This would enable member-states to compensate for any shortages that might arise (so-called 'reverse-flow'). They should also identify alternative supplies, such as liquefied natural gas (LNG).[25]

> *"The inverse of Europe's (partial) dependence on Russian gas is Russia's dependence on European demand."*

Not everyone is as sanguine as the Commission about the EU's ability to reduce its dependence on Russian gas. The Oxford Institute for Energy Studies points out that EU member-states have signed long-term contracts, ranging from 10-35 years, with Gazprom, obliging them to import 115 billion cubic metres of gas a year (the EU imported 162 bcm from Gazprom in 2013). Even if these obligations disappeared overnight, the Institute thinks that the EU would still need to import 100 bcm of Russian gas well into the next decade, once problems with alternative suppliers and limited EU infrastructure spending are taken into account.[26]

But the inverse of Europe's (partial) dependence on Russian gas is Russia's dependence on European demand. In 2013, the state energy giant Gazprom earned 58 per cent of its gas revenues from European countries (excluding those in the former Soviet Union).[27] The European Union will remain Russia's biggest customer for gas for some years to come. This could make Russia's cash-strapped government reluctant to turn gas supplies into a political weapon (which does not exclude threats to cut supplies, or even short-term reductions in volumes pumped). The European-Russian gas relationship is therefore a complex but not an insurmountable barrier to the EU taking a strong stance on Ukraine. Europe would in any case benefit economically and environmentally from reducing its overall demand for energy, whether fossil fuels from Russia or other forms of energy.

25: European Commission, 'Communication on the short-term resilience of the European gas system', October 2014; Stephen Tindale, 'The Commission's energy union 'strategy': A rebranded work programme', Centre for European Reform, February 27th 2015.

26: The Oxford Institute for Energy Studies, 'Reducing European dependence on Russian gas', October 2014.

27: Gazprom, 'Gazprom in figures 2009-13 factbook'.

Risk of sanctions: A financial crisis in Europe?

European financial institutions have lent generously to Russia and some could run into trouble if Russian companies begin to default on these loans. Around $147 billion is held by European lenders. France is the most exposed country with $44 billion, followed by Italy ($27 billion), Germany ($17 billion) and the UK ($15 billion).[28] So far, Russian companies have resorted to official funds to close funding gaps and the central bank is likely to ensure liquidity in the short term. But if large-scale defaults were to happen, some banks in the EU would require recapitalisation, potentially involving taxpayer money.

TABLE 6: European banks most exposed to Russia

Source: European Banking Authority, converted into USD

	Outstanding loans to Russia ($ bn)	Loss-absorbing capital ($ bn)	Result in 2014 banking stress tests
Sociéte Générale	31,4	46,4	Pass
UniCredit	23,3	49,6	Pass
Raiffeisen Zentralbank	19,5	11,3	Pass
Nordea	7,9	28,1	Pass
OPT Bank	3,9	4,9	Pass
Bank of Cyprus	2,3	2,2	Fail

Note: These banks are not the only institutions lending to Russia, but have reported that Russia is one of the top ten countries they lend to or acounts for at least 95 per cent of their exposure

However, the institutional setup to support troubled banks in the eurozone has improved significantly, with the ECB an established lender-of-last-resort both to banks and to sovereigns. Moreover, banks are not at risk of failing because of Russian defaults. To take one example, Société Générale, the bank most exposed to Russia, has $31.4 billion of outstanding loans to Russia, compared to loss-absorbing capital ('common equity tier 1 capital') of $46.4 billion.[29] The Austrian bank Raiffeisen Zentralbank is heavily exposed, but the Austrian government is capable of resolving a potential capital shortfall if markets are unwilling to invest in the bank. A further collapse in the Russian economy would reverberate in Europe but not tip the EU into another banking crisis.

The political impact of sanctions

Achieving agreement on the sanctions currently in force has not been easy for the EU. There are open disagreements between EU member-states over the value and impact of sanctions. So far, the EU has managed to find enough common ground to impose repeated rounds of sanctions and to agree to extend last March's (tier 1 and 2) sanctions until September 2015. But a successful charm offensive by Russia, or effective coercion, might be enough to get a small number of member-states to block renewal of sanctions later this year. The tier 3 sanctions which run out in July have a bigger effect not only on Russia but on Russia's Western business partners in the energy and financial services sectors.

Much will turn on whether Angela Merkel maintains her firm line: she has invested more than any other Western leader in the relationship with Putin, yet he has frequently reneged on commitments to her or resorted to outright lies about Russia's role in the conflict in Ukraine. If Merkel was initially inclined to look for face-saving ways to help Putin change course, the turning point for her may have been the shooting down of flight MH17, and the blizzard of contradictory stories from Moscow seeking to blame the Ukrainian side for it. After that, Merkel's spokesman said that she wanted rapid sanctions against Russia because it had shown no interest in investigating what happened to the airliner.

"Much will turn on whether Angela Merkel maintains her firm line: she has invested a lot in her relationship with Putin."

Much will also depend on Putin's efforts to show the West that he is strong enough to withstand any sanctions it could agree to impose, while Western countries are too weak to stand the effects of their own measures against Russia. European leaders like to claim that the EU's ability to agree as much as it has was a nasty surprise to Putin

28: Bank of International Settlements, 'Consolidated claims of reporting banks', January 2015.

29: European Banking Authority, '2014 EU-wide stress tests results', October 26th 2014. Credit exposure risk as of December 2013.

(which may be true); but they could have hit the Russian elite and the Russian economy much harder. The number of people and companies covered by EU sanctions, though it continues to grow, remains limited. Some senior figures close to Putin are not banned from the EU, though they are banned from other Western countries.

Tensions within the EU are growing, between supporters and opponents of sanctions – and between those who think that Putin's ambitions stretch beyond eastern Ukraine and those who think that he will be satisfied if he gets control of that area. A sizeable minority of EU member-states, including Austria, Cyprus, France, Greece, Hungary, Italy and others, have said more or less publicly that they want sanctions lifted as soon as possible. While America is creeping closer to supplying arms to the Ukrainian government, very few EU countries have supported it, and Angela Merkel and Francois Hollande have both expressed opposition.

Russia is also doing its best to create a split between the US and the EU (and within NATO) by suggesting that the US created the crisis in Ukraine and then forced Europe into imposing restrictions which are more damaging to EU member-states than to the US. Foreign minister Sergei Lavrov told a Russian TV station on September 13th that America wanted to separate Europe from Russia economically and thus improve its leverage in the talks over a transatlantic trade and investment partnership. In his remarks to the Munich Security Conference on February 7th, Lavrov suggested that the US had escalated the crisis in Ukraine and then influenced the EU to follow suit.

Russia has also differentiated between EU member-states. The decision to ban agricultural imports has affected Lithuania more than any other member-state; the president, Dalia Grybauskaite, has been among the most outspoken opponents of Putin's policy towards Eastern Europe. On the other hand, Germany, Russia's main trading partner in the EU, is much less affected by the counter-sanctions; and Putin has continued to use German chancellor Angela Merkel and French president Francois Hollande as his preferred interlocutors on Ukraine (while neither the EU high representative for foreign policy, Federica Mogherini, nor the president of the European Council, Donald Tusk, nor David Cameron has been involved).

> *"The longer sanctions continue without an improvement in Ukraine, the deeper divisions in the West will become."*

The longer sanctions continue without achieving the hoped-for improvement in the situation in Ukraine, the deeper the divisions within the West will become and the more likely that some countries will block renewal of sanctions. Or, since implementation is a national rather than an EU responsibility, and weakly policed by the Commission and the EEAS, they may simply stop implementing them.

Time for the West to re-assess sanctions and objectives?

The West certainly needs to re-evaluate collectively how far its sanctions are achieving their objectives. If it concludes that they are ineffective or only partly effective, the EU, US and other countries which have imposed sanctions on Russia have several alternatives:

– They can leave sanctions in place, in the expectation that their effects will grow over time, and because they want to give a permanent political signal that annexing territory is unacceptable. The economic crisis in Russia should make a change of course in Ukraine a rational choice for Moscow, at least if economic development is Putin's priority. But preserving a Western consensus in favour of renewing the sanctions over an extended period will become progressively harder, unless Russia takes further steps to provoke the West.

– They can lift sanctions and return to business as usual, as after Russia's invasion of Georgia in 2008. This is an unattractive precedent: if the West allowed aggression against one of Russia's neighbours to go unpunished for a second time, why would anyone take the threat of a Western reaction seriously the next time Russia (or any other country) decided to seize another country's territory?

– They can maintain the objectives but adjust the sanctions. There are many more individuals and entities which the EU could sanction, some already on American or other lists, including a number close to Putin. Putin himself is reputed to have significant wealth in the West, which only the US has so far (indirectly) targeted. As noted above, as last resorts they can shut Russia out of SWIFT or stop buying its oil and gas.

– They can maintain the sanctions but adjust the objectives. If they conclude that current sanctions will not make Russia give up the territory it has seized in Ukraine, they might reduce the objective to merely sending a clear signal that actions have consequences.

– They can adjust both sanctions and objectives. The new objective would be to constrain Russia's military modernisation. In this case, sanctions would aim to restrict Russia's economic growth and hence budget revenues, and to deprive the defence industrial sector of advanced Western military technology. If Putin were satisfied with a compromise solution in Ukraine which would also be acceptable to the West and to Ukraine itself, such a containment strategy might be unnecessary. But if Putin is determined to reassert Russian control over the foreign and domestic policy direction not only of Ukraine but also of Russia's other neighbours (as his rhetoric in the last year suggests), containment might be a key component of Western policy.

If the West decides to retain its current objectives, whether or not it adjusts the sanctions to achieve them, it needs to set out clearly the conditions for lifting them – essentially, complete implementation by Russia and its proxies of the terms of the February Minsk package. Even with full co-operation from Moscow, it will be a huge challenge for Kyiv to implement its side of the Minsk agreement, and the West is likely to need to cajole, encourage and support it. The Ukrainian economy is in a very bad state, and much of its industrial base, which was in the conflict area, has been damaged or destroyed. It will struggle to finance pensions and reconstruction costs in the separatist areas as the agreement demands. But the most important elements of the Minsk package in relation to Russian compliance are:

(a) Restoration of full Ukrainian control of the whole length of the border. This is scheduled to take place by the end of 2015, provided that 'local representatives' in the conflict zone agree that Ukraine has carried out enough constitutional reform. The EU should also press for permanent and comprehensive international monitoring of the border. This was foreseen in the September Minsk protocol, but not referred to in the February deal;

(b) free and fair elections in Donetsk and Luhansk regions, under Ukrainian law and without interference from Russia, monitored by election experts of the Organization for Security and Co-operation in Europe (OSCE). This would enable eastern Ukraine to be equitably represented in the Ukrainian parliament and to have properly constituted local government;

(c) the internationally supervised withdrawal of illegal armed groups (including undeclared Russian regular forces) and their weapons;

(d) full co-operation from the Russians and the 'separatists' with the independent investigation into the MH17 tragedy so that the perpetrators can face justice (this is not part of the Minsk package, but should be an essential condition for lifting sanctions, given the deaths of more than 200 EU citizens).

Crimea must not be forgotten. There may be a political consensus in Russia, uniting the authorities and the opposition, that it is now Russian territory; but the West cannot acquiesce in such a grave breach of international law. It must maintain measures to isolate Crimea and to sanction those Russians primarily responsible for its annexation. It should support Ukraine in any legal efforts to overturn the annexation or to seek redress for the theft of property. And it should keep an international spotlight on Russia's efforts to suppress the rights of Crimean Tatars and other minorities in Crimea.

> *"The West needs to ask what kind of Russia it is dealing with, and how Russia is likely to evolve."*

If the West concludes, however, that its current objectives are unachievable in the foreseeable future, then it needs to ask what kind of Russia it is dealing with, and how Russia is likely to evolve. In effect, until Russia challenged Ukraine's right to sign the EU association agreement, the assumption in most Western countries had been that with prosperity Russia would grow as fat and contented as EU member-states. Prosperous EU countries have slashed defence spending since the end of the Cold War, and have preferred since the start of the economic crisis to maintain their comfort rather than their defences.

As Russia's economy has rebounded from the economic meltdown of the late 1990s, however, it has ploughed ever more money into its armed forces. 70 per cent of the armed forces' weaponry is scheduled to be modernised by 2020. And Russia has not been afraid to use its forces: two wars in Chechnya killed perhaps 200,000 people; the invasion of Georgia left Russian-backed separatists in control of Abkhazia and South Ossetia; and the last year has seen the occupation of Crimea in a stunning and largely bloodless special forces operation, as well as the more violent seizure of parts of eastern Ukraine. Russian forces are exercising provocatively and aggressively near Western countries.[30]

Every Western leader wants to deal with a prosperous, peaceable Russia. The rhetoric of President Putin and his closest advisers strongly suggests that this is not on offer.[31] In these circumstances, the West has to consider whether it is better to deal with a strong and aggressive

30: Thomas Frear, Lukasz Kulesa and Ian Kearns, 'Dangerous Brinkmanship', European Leadership Network, November 2014.

31: For a good example, see the interview by Ivan Egorov with Nikolai Patrushev, Secretary of the Russian Security Council, in which he claimed that the US was seeking "the final destruction of our system of government and the ultimate dismemberment of our country", 'Second Cold War', *Rossiyskaya Gazeta*, October 15th 2014, published in English by *The Guardian*, October 24th 2014.

Russia or a weak but aggressive Russia. If the latter, then Western leaders should start considering how to redirect sanctions to support a policy of containment.

As a share of the state budget, Russia's military spending must already be close to the level which the Soviet Union found unsustainable. Finance Minister Siluanov said on March 2nd that 40 per cent of the 2015 state budget would go to defence, intelligence and law enforcement agencies. In such circumstances, the West has no interest in helping the Russian economy grow to the point where the military modernisation programme is once again affordable. It should look to strengthen sectoral sanctions, particularly in relation to technology transfer. The Co-ordinating Committee for Multilateral Export Controls (better known as COCOM) was set up by the West in 1950 and successfully delayed the Soviet Union's acquisition of new technology, forcing the USSR throughout the Cold War to rely on industrial espionage for modernisation; something like COCOM should be revived to replace the Wassenaar Arrangement (successor to the original COCOM, but with Russia as a member).

'Always keep a hold of nurse…': Is Putin as good as it gets in Russia?

Though Putin's KGB background and his vision of Russia as surrounded by hostile countries seeking to destroy the state are by no means unique in the elite, he personally is certainly responsible for some of the friction between the West and Russia.

Putin often talks, and acts, as though he believes that the Western goal in Russia is regime change. In fact, the evidence points in the other direction: Western politicians are keen to avoid any further instability in the region; and they tend to take seriously the suggestion that any successor to Putin would be worse. The Ukrainian American political scientist Alexander Motyl argued in September 2014, however, that the history of authoritarian regimes does not support this idea: Putin is equally likely to be succeeded by someone more or less the same mould as him, or by someone or some system that might be better (both for the West and for Russia itself).[32] As the Soviet Union began to disintegrate at the beginning of the 1990s, Western leaders tried to keep it together (both Margaret Thatcher and George H W Bush made statements implying opposition to Ukrainian independence); but on balance what came after, though far from ideal, has been better than what went before.

It would be counter-productive for the West to be seen actively fomenting regime change in Russia; but it should be prepared in case it happens. It should already be working against hard-liners and oligarchs who have profited most from their proximity to power, and keeping an eye open for any promising modernisers (as it did in the case of Mikhail Gorbachev before he came to power in the Soviet Union). The targeted sanctions against individuals close to Putin should now be expanded to cover other leading supporters of the regime and its Ukraine policy. The EU could make a start by imposing visa bans on individuals already sanctioned by the US, including for example Vladimir Yakunin, the head of Russian Railways. In November Yakunin attended a conference of eurosceptic and extreme right-wing parties in Berlin, thereby clearly working against the interests of the EU.

Whether or not sanctions against Russia remain in force, EU member-states should ensure that financial services firms in the EU are strictly applying anti-money laundering regulations, including in relation to members of the Russian leadership or companies close to them. In 2013 Moneyval (the Council of Europe's Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism) and Deloitte audited compliance with anti-money laundering regulations in Cyprus. This was a condition imposed on Cyprus by the EU and IMF as part of the bailout of Cypriot banks. It revealed "substantial shortcomings" in implementation of measures to prevent money-laundering, both by banks and supervisors.[33] In 2014, the Commission pointed to weaknesses in Latvia's implementation of anti-money laundering rules.[34] The Commission and the EEAS should set up a mechanism to ensure uniform, rigorous implementation both of the sanctions regime and anti-money laundering regulations by member-states. And the EU should be more transparent about the effect of implementation.

The Italian government pointed the way, by accident or design. It made use of what the Russians call *kompromat* – compromising material, or information that can be used to discredit an opponent – by publicising its freezing of properties worth €30 million belonging to Arkady Rotenberg, a businessman, sanctioned by the EU, with close links to Putin. The West should ensure that as much information as possible is made public about the wealth of Putin's circle and its origins, rather than welcoming Russian 'investment' with few questions asked. Leading Russian opposition figure and former owner of the Russian oil major 'Yukos', Mikhail

32: Alexander Motyl, 'Will Putin's successor be worse?', *World Affairs Journal*, September 22nd 2014.
33: European Commission, Directorate-General for Economic and Financial Affairs, 'The economic adjustment programme for Cyprus: First review – summer 2013'.
34: European Commission, Directorate-General for Economic and Financial Affairs, 'Assessing business practices in Latvia's financial sector' in *ECFIN Country Focus*, April 2014.

Khodorkovsky, told a conference in Vilnius in January that the West could do more to expose the corruption and money-laundering of Russian leaders.

Russia's economic problems have already cost many of Putin's supporters in the business community a significant part of their wealth: according to *Bloomberg.com*, Gennadiy Timchenko, Putin's former judo partner and the former owner of Gunvor, an oil trading company in which the US government alleges Putin has an interest, lost 62 per cent of his fortune in 2014, while Rotenberg lost 54 per cent. Putin has done his best to protect them by funnelling lucrative business in their direction: the gas company Novatek, co-owned by Timchenko, is involved in a major LNG project to supply gas to Europe and China; and Rotenberg's construction firm Stroygazmontazh has reportedly been awarded the contract to build a bridge from the Russian mainland to Crimea, at a cost of over $6 billion. But the poor state of the Russian economy as a whole means that the president will not be able to support his friends at the expense of the budget indefinitely. The consolidation of the elite around Putin may not last, if the 'pie' to be shared out is no longer big enough for all those at the table. Last September, Vladimir Yevtushenkov, an oligarch who was close to Prime Minister Medvedev but not to Putin, was placed under house arrest and stripped of one of his prize assets, the oil company Bashneft, before being released.

The West needs to pay more attention to the information war which Russia is waging, not only in Russian-speaking media or in Western countries through outlets like Russia Today (RT), but also in third countries. Russia has worked hard on cultivating emerging powers. This is partly a matter of pragmatism – countries like Brazil and Argentina are large agricultural exporters, able to make up at least some of the shortfall in imported food that has resulted from the Russian agricultural embargo. But Russia has also managed to get the other BRICS (Brazil, India, China and South Africa) to place a higher priority on resisting Western global leadership than supporting the principles of sovereignty and territorial integrity.

Within the BRICS, Russia has paid particular attention to China, and has been rewarded with political support: the Chinese vice premier, Wang Yang, said on October 11th that China "strongly opposes" sanctions against Russia. Russian leaders have for some time threatened Europe with the possibility that Russia will 'turn east', and have tried to portray the gas deal done between Russia and China in May in this light.[35] The reality is, however, that China has exploited Russia's political need to show that it can live without Western markets to drive a very hard bargain. Trade and energy negotiations which had dragged on for years were quickly brought to a conclusion in the margins of a meeting between Putin and the Chinese president, Xi Jinping, in May 2014, on terms which are far more favourable to China than Russia.

"The state of the economy means Putin will be unable to support his friends at the expense of the budget indefinitely."

The West cannot hope to overturn Russia's influence on the other BRICS overnight; but it could do more to explain to the democracies among them (both to governments and public opinion) why sanctions are an appropriate response to Russia's actions in Ukraine. The Russian case seems to have been made much more effectively than the Ukrainian or Western case. India, facing Chinese claims to territory on its northern border, should be more sympathetic to the importance of Ukraine's territorial integrity than it has been so far. The EU is the most important or second most important trading partner of Brazil, India and South Africa; Russia is not among the top ten partners of any of them. Yet these economic links have not so far translated into a political partnership for dealing with Russia (or, indeed, most other international security crises). As long as the other BRICS are prepared to replace Western exports to Russia which now banned, albeit at higher costs for Russian consumers, sanctions will be less effective than they should be.

Conclusion

The purpose of sanctions is not to punish a state, but to change its policy. But a sanctions regime can only work if the costs of sanctions fall primarily on the state being sanctioned. Assessing these costs is therefore crucial. On this score, European leaders should feel reassured. Sanctions are weighing more heavily on Russia than on the EU. They are amplifying Russia's other economic problems: the falling oil price (a particular problem for an administration that depends on natural resources for a large chunk of its revenues); a falling currency; high interest rates; and a credit crunch.

The dilemma that may face the West at some point is whether the Russian economy is in such a bad state that it risks a collapse on the scale of the Soviet economy in the late 1980s (also a time of low oil prices and high defence expenditure). Political leaders will be susceptible to arguments that Russia is 'too big

35: Ian Bond and Rem Korteweg, 'Russia's gas deal with China: Business is business', Centre for European Reform, June 25th 2014.

(and dangerous) to fail', and that the world cannot afford a failed state with nuclear weapons. But the West has done nothing yet that could bring down the economy as a whole; and nor would lifting the existing economic sanctions make much difference to Russia's long-term prospects (though it would reduce the risk of a Russian corporate debt crisis in 2015). Even if the economy deteriorated further, bailing out Russia under any version of its current leadership and system looks very unattractive. The scale of capital flight in 2014 shows that the Russians themselves do not have the confidence to invest in their country; the West should not repeat the mistake of the early 1990s when Russians exported capital as fast as the IMF and other international investors could inject it.

In comparison with Russia, the EU is more diversified and resilient to shocks. The eurozone remains very weak, and some countries, such as Italy, have a limited appetite for further weakening their economies through sanctions or an escalating crisis, however strategically important the goal might be. In order to create the necessary room for manoeuvre for its foreign policy, the EU should step up its plans to invigorate its economy: a more aggressive monetary policy, some fiscal relaxation in the periphery, stimulus in the core countries, as well as a substantial European investment programme should be key priorities. With the German economy weakening and Russian aggression intensifying, Angela Merkel might finally throw her political weight behind a proper growth agenda.

If the sanctions imposed by the West have been effective in imposing at least some economic pain on senior Russians and on the Russian economy more generally, so far they have not persuaded the Russian authorities to change course. There is no sign of Putin looking for ways to exit Donetsk and Luhansk, let alone Crimea. Indeed, even Russia's most prominent opposition figures, Aleksey Navalniy and Mikhail Khodorkovsky, have said that Crimea should remain part of Russia.[36] The only exception was the late Boris Nemtsov, murdered in Moscow on February 28th, who argued that it was an integral part of Ukraine – though even he favoured giving the Crimean population another referendum to decide its future.

Putin is striving to persuade people both that the sanctions are having no effect on Russia and that they are doing much greater damage to the West. This paper has shown that neither assertion is true: at the very least, sanctions are exacerbating the serious long-term problems of the Russian economy. But faced with insistent Russian propaganda to the contrary, European leaders need to find ways to set out a counter-narrative for the Russian people. Given the growing clampdown on independent media, and the anti-western hysteria coming from state broadcasters, the difficulty of this task cannot be underestimated. Nevertheless, the EU should look to boost its soft power, to create policies that allow people to move across borders, even when capital and goods are forbidden.

> *"To create room for manoeuvre for its foreign policy, the EU should step up its plans to invigorate its economy."*

To this end, it should do what it can above all to keep the door open to ordinary Russians, including through academic exchange programmes such as Erasmus Plus (which funds university student exchange programmes, among other things) and through a vastly increased public diplomacy and information effort. Apart from countering Russian mythology about the decadence and decline of the EU, and building links between young Russians and their Western counterparts, the West should show that there is a difference between opposing Putin's policies and seeking to harm Russia as a state or Russians as people.

At the same time, the West must remain resolute on the substance of its arguments. In January, European foreign ministers reaffirmed that sanctions on Russia should stay in place, and extended the original Crimea-related sanctions until September. They did not adopt the suggestion in the EEAS January 'issues paper' that in the context of 'trade-offs' between EU and Russian policy objectives, the EU could restart dialogues with Russia on foreign policy, trade, energy, visa facilitation and other topics. This was the right decision. At the time of writing, the ceasefire which began on February 15th, after the Minsk summit meeting, is generally holding, though not everywhere. Russian forces and heavy equipment remain inside or on the borders of eastern Ukraine. Meanwhile, the Dutch-led MH17 investigation is far from over, complicated by the fact that the crash site is in a war zone. In these circumstances, the EU cannot roll back sanctions until the issues for which it imposed them have been addressed.

A change in Russia's policy towards its neighbours may not come quickly. Putin will probably run for a fourth presidential term in 2018. And if he does, he will probably win, aided by an increasingly powerful state media machine and a political system that silences opposition. Putin may seek a rapprochement with the West, but it seems plausible that he will try to preserve a frozen conflict in eastern Ukraine, while attempting to expand Russia's domestic industry (under tighter

36: Navalniy favoured holding a fresh referendum, which he was confident the pro-Russian campaign would win.

state control) to keep its economy going. The Russian president may be counting on a collapse in western resolve, for instance a decision to lift sanctions in return for a reasonably effective ceasefire in eastern Ukraine, once the Ukraine crisis drops down the news agenda.

But it would be a terrible mistake, with global implications, for Western leaders to go back to business as usual with Russia, following a forced change of borders and the annexation of the territory of a sovereign state. If they do not want to respond with military force, then economic and political measures to constrain and deter Russia are the only alternative. The West must hope that that eventually a Russian leader will appear who thinks that Russia is stronger when its neighbours are its friends than when they are its subjects. Meanwhile, the Kremlin must know that destabilising Eastern Europe will carry a high cost for Russia.

Ian Bond
Director of foreign policy, Centre for European Reform

Christian Odendahl
Chief economist, Centre for European Reform

Jennifer Rankin
Journalist in London, who has worked in Brussels and Moscow