



# FOREIGN AFFAIRS

## The Failure of Western Restrictions Against Russia

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December 14, 2015

After Russia seized Crimea from Ukraine in March 2014, the Obama administration responded with what has become the go-to foreign policy tool these days: targeted sanctions. The United States placed asset freezes and travel bans on more than one hundred people, mostly cronies of Russian President Vladimir Putin, and the EU targeted almost a hundred more. The amounts involved have been massive: Bank Rossiya, the Kremlin's preferred bank, had \$572 million frozen in the months after the sanctions were rolled out. Then, in July 2014, when Malaysia Airlines Flight 17 was shot down over eastern Ukraine allegedly by Russian-backed forces, Washington responded with more severe sanctions aimed at key sectors of the Russian economy, including arms manufacturers, banks, and state firms. In an effort to hit the Kremlin where it hurts, the measures inhibit financing and technology transfers to Russian oil and gas companies, which supply over half of state revenues.

Considering the dire state of Russia's economy, these sanctions might appear to be working. The value of the ruble has fallen by 76 percent against the dollar since the restrictions were imposed, and inflation for consumer goods hit 16 percent in 2015. That same year, the International Monetary Fund estimated, Russia's GDP was to shrink by more than three percent.

In fact, however, Western policymakers got lucky: the sanctions coincided with the collapse of global oil prices, worsening, but not causing, Russia's economic decline. The ruble's exchange rate has tracked global oil prices more closely than any new sanctions, and many of the actions taken by the Russian government, including the slashing of the state budget, are similar to those it took when oil prices fell during the 2008 financial crisis. The sanctions have inhibited access to Western financing, forcing Russian banks to turn to the government for help. This has run down the Kremlin's foreign reserves and led the government to engage in various unorthodox financial maneuvers, such as allowing the state-owned oil company Rosneft to recapitalize itself from state coffers. Yet the Russian government has been able to weather the crisis by providing emergency capital to wobbling banks, allowing the ruble to float freely, and making targeted cuts to the state budget while providing fiscal stimulus through increased spending on pensions. Even with continued low oil prices, the International Monetary Fund expects that growth will return to the Russian economy in 2016, albeit at a sluggish 1.5 percent.

Nor are the sanctions inflicting much pain on Russia's elites. Although Prada and Tiffany are doing less business in Moscow, the luxury housing market is anemic, and travel bans rule out weekend jaunts to Manhattan, these restrictions are hardly unbearable. One target, the close Putin adviser Vladislav Surkov, has dismissed them as harmless. "The only things that interest me in

the U.S. are Tupac Shakur, Allen Ginsberg, and Jackson Pollock,” he said. “I don’t need a visa to access their work.”

And when the sanctions are judged by the most relevant metric—whether they are producing a policy change—they have been an outright failure. Since the United States imposed the sanctions, Russia has not backed down in Ukraine, and there is no reason to believe that they will force it to do so anytime soon. In the meantime, however, the sanctions are harming U.S. economic and geopolitical interests. If Western leaders want to resolve the Ukraine crisis and meaningfully constrain Russia’s bad behavior, they should abandon their failed sanctions-centric policy and focus on other measures instead, such as efforts to aid Ukraine economically, obstruct Russia’s military modernization, and increase European energy independence.

### **Unintended Consequences**

Whatever punishment the sanctions have inflicted on Russia, it has not translated into coercion. The Obama administration appears to have expected that it would have by now: in February 2015, for example, Christine Wormuth, the U.S. undersecretary of defense for policy, admitted that the sanctions had “not changed so far what Russia has been doing on the ground, and that is the great concern.”

Indeed, after the initial round of sanctions, the Kremlin’s aggression only grew: Russia formally absorbed Crimea and upped its financial and military support for pro-Russian rebels in eastern Ukraine (including those who most likely shot down the Malaysia Airlines flight). It is possible that the sanctions may have deterred Russia from even greater aggression in Ukraine, but it is equally possible that all Russia ever wanted to do there was create a slow-burning insurgency. And at any rate, the sanctions have failed to force Russia to withdraw from Crimea and stop meddling in eastern Ukraine. This should not be surprising: as the most comprehensive study of sanctions found, they fail to achieve their goals in 66 percent of cases, and they fail 79 percent of the time when designed to discourage military misadventurism.

The Kremlin’s aggression has persisted in large part because the West’s targeted sanctions have succumbed to the same problem that plagues traditional comprehensive sanctions: the targeted regime shelters its cronies, while the rest of the population suffers. It wasn’t supposed to be this way. Modern sanctions are designed to avoid replicating the flaws of the comprehensive embargo placed on Iraq during the 1990s, which served only to enrich Saddam Hussein’s regime and impoverish the Iraqi people. With Russia, the U.S. government made sure not to bar overall trade and instead imposed asset freezes and financing restrictions on individual politicians and companies. In theory, members of Putin’s inner circle would use their influence to convince the president to reconsider his bellicose Ukraine policy.

In practice, however, the sanctions have had the unintended consequence of inflicting widespread punishment on the Russian economy and population. By restricting access to international financing during a recession, the sanctions have compounded the fall in oil prices, requiring Moscow to slash spending on health care, infrastructure, and government salaries, which has created economic hardship for ordinary Russians. The crash of the ruble, meanwhile, has not only destroyed savings but also increased the monthly payments of those who hold mortgages denominated in foreign currencies. The government, in turn, has pressured struggling Russian banks to convert such debt into rubles and absorb the losses, which has rescued homeowners from default but run down banks’ capital reserves.

Adding to the pain was the Russian government's decision to issue its own set of sanctions, which have barred the import of Western foodstuffs. Although the move has hurt eastern European farmers and exporters, it has also created shortages and increased food prices inside Russia. Then there was the unforeseen credit crunch among ordinary consumers. Fearful of a legal backlash, many U.S. and European banks cut off not only billionaire bank owners but also many of their customers. In March 2014, for example, Visa and MasterCard suspended all transactions from four Russian banks in response to sanctions placed on its owners, effectively canceling the credit cards of ordinary Russian consumers. The U.S. government had to intervene to convince the companies to start processing payments again.

At the same time that the sanctions have punished the population at large, the Kremlin has sheltered key supporters from their impact. For example, from March to December 2014, companies linked to the Putin cronies Arkady Rotenberg and Gennady Timchenko received 12 percent more in government contracts than they had during the entire previous year. The government also stripped Russia's largest private bank, Alfa-Bank, of a lucrative contract to service the country's electricity market, awarding it instead to Bank Rossiya.

The Kremlin has also managed to circumvent the sanctions, partly by turning to China. In May 2014, Putin visited the country to seal a 30-year, \$400 billion gas deal with it, demonstrating that Russia has alternatives to European gas markets. That October, Moscow and Beijing also agreed to a 150 billion yuan currency swap, allowing companies such as Gazprom to trade commodities in rubles and yuan—and thus steer clear of U.S. financial regulations. Even in Europe, Russia has been able to find loopholes to avoid the sanctions: in order to obtain access to Arctic drilling equipment and expertise, Rosneft acquired 30 percent of the North Atlantic drilling projects belonging to the Norwegian company Statoil.

It is tempting to believe that the sanctions will eventually work—say, after a few more years—but that is wishful thinking. U.S. and European negotiations with Russia have focused on the near future, including the implementation of the Minsk II agreement, an armistice with a deadline of December 2015, and with good reason: a drawn-out insurgency is the worst-case scenario for Ukraine and its Western backers. The sanctions were intended to compel Russia to cooperate with this international diplomatic process and withdraw from Crimea; if it doesn't do so before the Minsk deadline, it is unlikely to in the future. Indeed, as academic studies suggest, the longer sanctions are in place, the less likely they are to produce a policy change. And in the case of Russia, if the price of oil rises again in the next few years, as is likely, their impact will diminish further.

### **The Costs Of Containment**

It is true that the sanctions have allowed the Obama administration to claim that it is doing something about Russian aggression. From the White House's perspective, that might be an acceptable rationale for the policy, so long as there were no downsides. In fact, however, the sanctions carry major economic and political costs for the United States and its European allies.

The brunt is being borne by Europe, where the European Commission has estimated that the sanctions cut growth by 0.3 percent of GDP in 2015. According to the Austrian Institute of Economic Research, continuing the sanctions on Russia could cost over 90 billion euros in export revenue and more than two million jobs over the next few years. The sanctions are proving especially painful for countries with strong trade ties to Russia. Germany, Russia's

largest European partner, stands to lose almost 400,000 jobs. Meanwhile, a number of European banks, including Société Générale in France and Raiffeisen Zentralbank in Austria, have made large loans to Russian companies, raising the worrying possibility that the banks may become unstable, or even require bailouts if the borrowers default.

In the United States, banks are taking much of the impact. U.S. financial institutions have been required by law to freeze and manage tens of millions of dollars in assets of sanctioned individuals. As a result, the banks have had to hire additional legal and technical staff to not only monitor their own accounts but also review any financing arrangements with Russian entities. Failure to comply with the sanctions can be extremely costly: just one error, such as processing a single payment from an interdicted individual, can carry a penalty of up to \$250,000, and the penalties can quickly multiply. In 2010, the Dutch bank ABN AMRO was fined \$500 million for violating U.S. sanctions against Cuba, Iran, Libya, and Sudan.

U.S. energy companies, for their part, have had to abandon various joint ventures in Russia, losing access to billions of dollars of investments. Thanks to prohibitions on the provision of technology and services to Russian companies, Western firms have been kept out of unconventional drilling projects in the Arctic and elsewhere. ExxonMobil, for example, has been forced to withdraw from all ten of its joint ventures with Rosneft, including a \$3.2 billion project in the Kara Sea. Because that project was in its early stages, the cancellation will not cost ExxonMobil in immediate profits. But it will cut access to upstream development projects inside Russia, putting the company's future profits and stock valuation at risk and raising the possibility that the money already invested will be permanently lost.

A similar dynamic may harm European energy security, too. Because the sanctions prohibit Western companies from financing Russia's largest energy firms, the Russian companies have cut back on upstream exploration and development. In this, the sanctions may achieve their intended goal of reducing state revenue, but that will come as a result of shortfalls in supply. The energy consultancy IHS Cambridge Energy Research Associates has predicted that if the sanctions persist, Russian oil production could decrease from 10.5 million barrels per day now to 7.6 million barrels per day by 2025—bad news for European states, which receive one-third of their oil from Russia. They are even more dependent on Russian gas, which, since it relies more on fixed pipelines, is harder to replace.

But it is in the realm of Russian politics that the sanctions have been most counterproductive. The sanctions have had a “rally round the flag” effect as the Russian people blame their ills on the West. According to the Levada Center, a Russian research organization, Putin's approval rating increased from 63 percent during the invasion of Crimea to 88 percent by October 2015. In another poll, more than two-thirds of respondents said they thought the primary goal of the sanctions was to weaken and humiliate Russia. State propaganda is of course playing a role, but the sanctions have made it easier for Putin to sell his anti-Western narrative. They allow him to deflect blame away from his own economic mismanagement and toward what he has called “external factors.”

The sanctions are also having the perverse effect of enabling Putin to further consolidate his power, because he has rewarded his closest cronies at the expense of other elites. According to data from *Forbes'* list of billionaires, Russia's 15 richest citizens lost an average of 20 percent of their wealth in 2014, before regaining 12 percent in the next six months as the market stabilized.

These fluctuations track the broader Russian economy, but after one breaks down the data, some telling disparities emerge. On average, those billionaires who held stakes in sanctioned companies lost less than three percent of their wealth between January 2014 and June 2015, whereas those who did not lost nine percent. It requires no great leap of logic to see that the Kremlin has shielded those with connections to the ruling circle from the pain of the sanctions, thereby shifting the burden to those without such ties.

The sanctions have also encouraged Russia to create its own financial institutions, which, in the long run, will chip away at the United States' economic influence. After U.S. senators and some European governments suggested that the United States might cut off Russia's access to the Society for Worldwide Interbank Financial Telecommunication (SWIFT) payment system, the Russian Central Bank announced that it was going to start negotiations with the other BRICS states—Brazil, India, China, and South Africa—to create an alternative. To lessen its dependence on Visa and MasterCard, Russia has made moves toward setting up its own credit-card clearing-house. And it has moved ahead with the proposed BRICS development bank, which is designed to replicate the functions of the World Bank and the International Monetary Fund.

Although none of these initiatives has come to fruition yet, they raise the worrying possibility that the United States will someday have a harder time employing economic statecraft. Even though sanctions have failed with Russia, they can work against smaller states, which, since they lack the cash reserves and ability to ramp up domestic production, cannot so easily compensate for the cutoff of foreign trade and investment. But in a world where more institutions fall outside the reach of the United States and its allies, those targets can more easily circumvent U.S. sanctions. The recent measures directed at Iran for its nuclear program, for example, would have been less likely to drive the regime toward the bargaining table had it been able to turn to alternative organizations for transaction and financing support. Likewise, Russia's shift away from trading in the dollar could make future U.S. sanctions less effective, since transactions structured as currency swaps do not require access to the U.S. financial system.

### **Accepting Failure**

If the United States continues to insist that the sanctions against Russia need more time to work, then the costs will continue to add up, while the likelihood of changing the Kremlin's behavior will get even slimmer. The West does indeed need to respond to Moscow's adventurism, but it should do so largely through other means.

To start, the Obama administration should make one final attempt to obtain some benefit from the sanctions, offering to lift the most onerous restrictions on Russia's financial and energy sectors in exchange for Russia's implementation of the Minsk agreement. If the offer were accepted, it would constitute at best a minor success for U.S. sanctions policy: the Minsk agreement has been primarily the result of persistent diplomacy by French and German leaders, and U.S. sanctions were aimed at securing not just peace in eastern Ukraine but also unconditional Russian withdrawal from Crimea. Given the Kremlin's past unwillingness to compromise, however, such an offer would most likely be rejected. In that case, the United States should cut its losses and unilaterally lift the majority of the sanctions on Russia.

As for the lower-cost sanctions aimed at specific, narrow goals, those may as well be kept in place. Travel bans on individual elites should last for several more years. These restrictions carry low costs—the burden of which falls primarily on governments, not businesses—and will

continue to inconvenience elites close to Putin, hopefully deterring future aggressive actions to some extent. Sanctions on entities directly involved in the annexation of Crimea should also be retained, since they are aimed not at coercion but at preventing Russia from profiting from the seizure, a goal that is far more likely to succeed.

Sanctions that impede Russia's military modernization have a role to play, too. Not only should the United States and Europe expand the long-term asset freezes and financing bans on Russian weapons manufacturers; they should also enact new bans on the import of arms from western Europe, particularly on major purchases, such as the Mistral helicopter carriers that Russia ordered from France before the deal was canceled in August 2015. None of these measures is likely to coerce Russian leaders into changing course in Ukraine, but they could make it trickier for Russia to engage in future military misadventures.

After winnowing the sanctions, U.S. diplomats should seek to work with their Russian counterparts on issues unrelated to the Ukraine crisis. The United States and Russia collaborated on the Iran nuclear deal, and despite Russia's recent intervention in Syria, there is still room for cooperation on ending the civil war there. Although Washington and Moscow disagree about the future of the Assad regime, they both have an interest in preventing the growth of the Islamic State, or ISIS, and there is good reason for the two powers to try to craft a multilateral political solution to Syria's crisis. Engaging Russia on this and other non-Ukrainian issues would avoid isolating it diplomatically and thus discourage it from creating or joining alternative international institutions.

The United States should also give additional economic aid to Ukraine. Although any aid program must grapple with Kiev's long-running corruption and governance problems, increased assistance would help the Ukrainian government address its economic woes, rebuild from conflict, and ultimately become less economically dependent on Russia.

Finally, to starve the Russian state of revenue in the long term, Washington should try to provide Europe with an alternative source of energy. Even though the United States is the world's biggest producer of oil and natural gas, U.S. federal law currently bans the export of crude oil, and the Department of Energy requires a special waiver for the export of liquefied natural gas. In October, the House of Representatives voted to lift these restrictions, but the president threatened to veto the bill. That's a shame, since the move would not only benefit U.S. companies and consumers but also allow European states to wean themselves off Russian oil and gas. As Russian energy companies lost customers, the state's revenues would decline. And unlike the sanctions, this policy would help, not hurt, European energy security.

It is difficult to accept when a policy does not work. To its credit, the Obama administration has done so in Cuba, by resuming diplomatic relations, and in Iran, by choosing to negotiate. It is time to admit failure in Russia, too. Because the high costs of Western sanctions cannot be justified by their limited impact, the United States would be better off trying a policy with fewer downsides, and with greater odds of success.

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