The Economic Impact of EU and NATO Sanctions on the Russian Economy

Ismaila Bojang, James Okrah

Abstract— this paper assesses the impact of the EU and NATO sanctions on the Russian economy. An examination of the data revealed that the sanctions have directly impacted on various sectors of the Russian economy. Notable among them were the financial sector which includes the banks, major publicly owned companies in the fuel/energy sector as well as the military and technological equipment. These sanctions severely constrained these sectors as they struggled with lack of funding and investment. The economy also witnessed huge capital flight or outflow at an estimated value of $7.8bn, which was further compounded by gross negative capital inflow in the form of FDI's (foreign direct investments). In addition to that, the embargo on food imports as well as trade sanctions led to a rise in inflation, which further resulted, to a rise in commodity prices and by extension loss of confidence in the falling Ruble. The sanctions also led to erratic trade flows and loss of market share. On the contrary, despite the sanctions the Russian economy moved to 45th place in the global competitiveness report. Besides the Russian government continuously offer support to its financial institutions in the form of low interest loans which led to their buoyancy.

Keywords: Sanctions, Import, Export, competitiveness, Inflation, External debt, FDI

1 INTRODUCTION

Trade is the backbone of every economy, Countries trade in various spheres to satisfy various economic needs. As the saying goes" No one is an Island" i.e. No Country stands alone, to which Russia is not an exception. Russia trade with most of the Countries in the world and that has a positive influence on the total performance of the Economy.

As stated by Focus economics "The Russian economy eked out unexpected growth in the last quarter of 2014, demonstrating resilience in the face of geopolitical headwinds, International sanctions, a falling *ruble* and lower oil prices."

When Russia annexed Crimea and started interfering in Eastern Ukraine, the West responded with economic sanctions. In July 2014, the European Union, the United States, Canada, and other Allies and partners enacted sanctions in a coordinated manner.

The sanctions targeted three most important areas of the Russian economy such as:

i. Restriction of access to Western financial markets and services for designated Russian state-owned enterprises in the banking, energy, and defense sectors.

ii. Restrictions on exports to Russia of specific high technology, oil drilling as well as production equipment.

iii. Restrictions on exports to Russia of special military equipment and dual-use goods.

The sanctions that blocked access to funds literally forced the Russian government to consume a portion of its foreign currency reserves to mitigate the sanctioned entities. These developments forced the Central Bank of Russia, which suddenly withdraw its support of the Ruble and hike interest rates in December 2014. In December 2015, the Ruble reached its lowest and it was very tragic for the economy.

There was a high food price due to the embargo on the import from European countries, which subsequently resulted to the skyrocketing of inflation.

2. Theoretical Review

2.1 Overview of the Russian economy

The EU's foreign policy instruments are limited to 'soft power'. This is the ultimate reason why the European Union's reaction to Russia's annexation of Crimea, which followed military intervention in Eastern Ukraine, comprised mainly of the imposition of economic sanctions (Daniel & Federica, 2015). Meanwhile, this act of imposing specific sanctions by the European Union on Russia was greeted by counter sanctions from the Russian government. They decided to ban the importation of certain perishable commodities like (fish, meat and vegetables) from countries that subscribe and support the sanctions of the EU.

The Russian economy has undergone major changes since the collapse of the USSR, which saw its economy transforming from a centrally planned/communist type to a more market oriented type. Economic growth over the years has been moving on a snail's pace, which prompted the government to push for re-

International Journal of Scientific & Engineering Research, Volume 8, Issue 4, April-2017
ISSN 2229-5518

forms in certain key aspects of the economy, in a bid to drive growth. Economic reforms in the 1990s privatized most industry, with notable exceptions in the energy, transportation, banking and defense-related sectors.

Russia is one of the world's leading producers of oil and natural gas, metals which includes steel and Aluminum. After a turbulent political and economic transition in the 1990s, Russia experienced over a decade of high and almost uninterrupted economic growth, driven largely by a super cycle commodity boom, particularly historically high oil prices (The World Bank, 2016). Meanwhile it suffers from the continuous fluctuations of prices of commodities as it relies heavily on commodity exports thereby experiencing volatile swings in global prices.

However, the economy which, had grown on an average of 7% within the years of 1998-2008 was highly credited to the rapid increase in oil prices, which later culminated in diminishing growth rates as a result of the exhaustion of the commodity-based growth model. In addition, falling oil prices, international sanctions as well as structural constrains among a host of others, propelled Russia into a deep recession in 2015 with GDP dropping by almost 4%. According to focus economics, this trend is expected to continue through 2016. However, the Russian economy pulled off an unexpected growth in the last quarter of 2014, thereby showcasing resilience in the face of the ever-changing geopolitical landscape as well as international sanctions, a rapidly depreciating Ruble and falling oil prices. However, the start of 2015 has brought signs of contraction as negative growth momentum has been picking up speed. According to focus economics report 2015, the deterioration of the economy and lower tax intake from the hydrocarbons industry, the Finance Ministry presented new fiscal projections for this year which indicates a fiscal deficit of3.8% of GDP. Although the Russian Ministry of Economic Development is forecasting a modest growth of 0.7% for 2016 as a whole, the Central Bank of Russia (CBR) is more pessimistic and expects the recovery to begin later in the year and a decline of 0.5% to 1.0% for the full year.

.

According to Evsey G. & Ilya P (2015) the sanctions were mostly directed at banks such as (Sberbank,VTB, Gazprombank, Rosselkhozbank, Vneshekonombank, Bank of Moscow) and major publicly owned companies in the fuel/energy sector (Rosneft, Transneft, Gazpromneft) and in the military-industrial complex (Uralvagonzavod, Oboronprom, OAC e.t.c.) This is evidenced by their decreasing financial and competitive performance. The prevalence of the financial effects of the sanctions during the first years, resulting in reduced investment and consumption, is manifested in the works of (Sinyakov et al., 2015 & Shirov et al., 2015).

Meanwhile, Ulyukaev and Mau (2015) identified the main channels affected by the sanctions. Their classification was based on the following components:

i. Increasing uncertainty (beginning even before the sectorial sanctions were introduced) slows down consumption due to rising precautionary savings (often in USD) and dwindling investments due to higher risk premiums;
ii. Increased cost of debt financing limits access to refinancing, thereby affecting investment opportunities for companies. Moreover, restrictions on technology exports to the Russian Federation constrained the potential growth of total factor productivity; and
iii. Production in sectors dependent on imported components suffers from the ruble's sharp fall.

The effect of the sanctions has serious impact on the economy of Russia. According to the Bank of Russia, during the second half of 2014, the foreign debt of the banking and non-financial sectors decreased by USD 83.6 billion and that of banks and companies that were more than 50% publicly owned fell by USD 41.1 billion (without considering liabilities to direct investors) (Evsey et al. (2015). Furthermore Evsey et al. (2015) argued that the capital outflow from the public sector broke a record during the first quarter of 2015(-USD 7.8billion); in this case, however a significant contribution was made by the downgrading of Russia's sovereign rating, which was likely to have automatically led to sales of securities by many institutional investors.

According to a World Bank Report, in the first quarter of 2014, growth sank to 0.9% from a value of 2.0% in the last quarter of 2013 and maintained that position for the rest of the year. The rapidly deteriorating economic situation of Russia is manifested in its level of inflation.

2.3 Types and the nature of sanctions

The sanctions were initially put in place by the EU and the US in reaction to Russia's annexation of Crimea. The sanctions were categorized into three levels such as:

- Tier 1 and 2 sanctions (Asset freezes and visa bans)- the West agreed to freeze assets and impose travel bans on some Russian officials, pro-Russian militia as well as a ban on doing business with organizations or companies that were complicit in the Russian annexation of Crimea. Meanwhile, these restrictions came into force in March 17th, 2014 and were extended all the way to September 2015. On December 20th, the EU banned European investment in Crimea and by extension providing financial and other assistance to Crimean companies.
- Tier 3 sanctions (Economic sanctions)- following the aftermath of the shooting down of flight MH17 on July 31st, the EU again imposed another round of sanctions targeting four areas which

International Journal of Scientific & Engineering Research, Volume 8, Issue 4, April-2017
ISSN 2229-5518

includes; restrictions on lending to Russian state banks, an arms embargo, an export ban on oil technology and services that could be used for Arctic or deep-sea drilling, or shale oil projects and export ban on dual-use goods. These include equipment such as special computers or heavy engineering vehicles that could be used for military purposes. The sanctions also included limited access to primary and secondary capital markets in the EU (Russian financial Institutions, Energy and Defense).

However, Russia also responded to the EU sanctions putting in place counter sanctions, which include a ban on the importation of food. The government of 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. However, baby food was exempted.

3. Inflation

One negative impact of a falling Ruble was inflation. Food prices in Russia have increased dramatically over recent months as a result of the counter sanctions on food imports that were imposed on August 2014. This definitely lowered the real incomes of households thereby reducing their purchasing power. To this effect, spending less on Russian goods is affecting the economy. According to Bond et al. (2015) the effect of the falling Ruble is also felt on interest rates. In an attempt to stabilize the currency, the Bank of Russia raised its key rate to 17%. With non-food inflation at 9%, that means that real interest rates are high at around 8%, which is depressing consumption and investment.

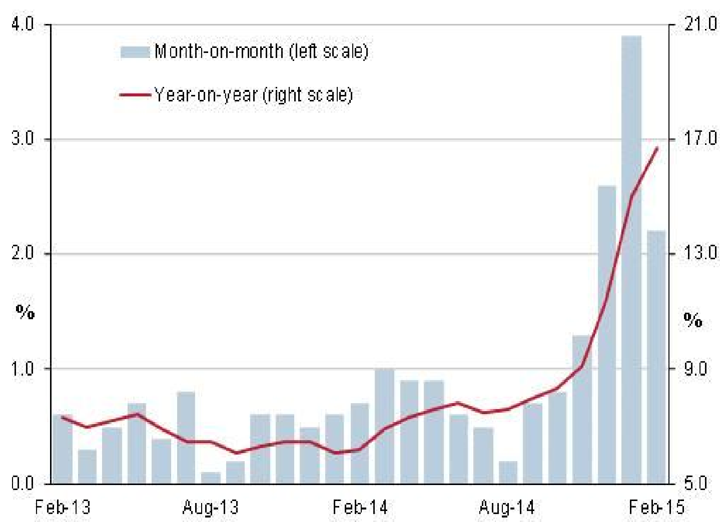

Fig. 1 Source: Federal State Statistics service (Rosstat).

Based on the information in the graph, the embargo on food import and other trade restrictions cause a rise in inflation, which also caused an increase in food prices as well as a loss of confidence in the currency of the country (Rubles).

However, despite the monthly moderation, the inflation is expected to reach its peak in the second quarter this year due to effects of the ruble's sharp depreciation and the government's embargo on food imports from some western countries.

According to the Russian Finance Ministry's expectation concerning inflation, it will reach a peak of more 17% in the first half of this year before reducing in the second half. The Ministry projected that inflation will fall below 12.0% by the end of 2015.

4. Exports and Imports

In February, Russian exports totaled USD 29.2 billion, which represented a 19.9% contraction of the same month last year. Meanwhile, the imports equally reduced with a value of 35.4% annually in February, which strikes a balance between the two values, in comparison with a rapid contraction of 40.7% registered in January.

Fast on the heels of a temporary recovery in February, the price of Ural oil which represents Russia's main export commodity declined. At the end of March, a barrel was traded at USD 52.4, which was 13.3 % lower than the previous value registered in February. Meanwhile, despite expectations that the oil prices will remain low this year, the Authorities have confirmed that they will not reduce oil output. According to the Russian Central Bank's economic assessment outlook, two scenarios are involved. A baseline scenario that indicates that the price of Ural Oils to average USD 80. In the worst-case scenario, the Bank sees oil prices averaging USD 60.

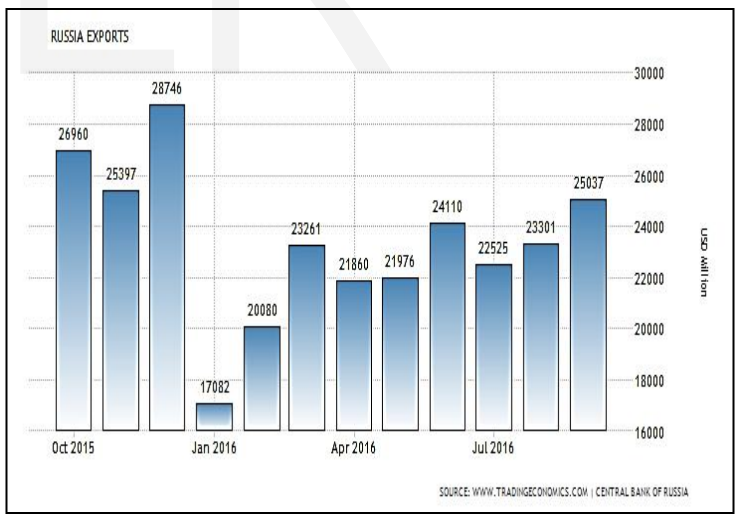

Fig. 2 Source: www.tradingeconomics.com Central Bank of Russia.

5. Increasing external debt

Another impact of the sanctions on the Russian Economy is the increase in the value of external debt. The current external debt of banks and firms stands at $600 billion; fallen by $130 billion over the past six months as international investors were unwilling to roll over maturing debt (Bond et al. 2015). This shows an increasing trend for foreign debt which rose from 24.9 trillion to 33.8 trillion over

International Journal of Scientific & Engineering Research, Volume 8, Issue 4, April-2017
ISSN 2229-5518

the same period. Meanwhile, external debt decreased to $516.10 billion in the 3rd quarter of 2016 from $521.50 billion in the 2nd quarter of 2016. The external debt averages $444.31 billion from 2002 till 2016 thereby reaching and all time value of $732.80 billion in the second quarter of 2014 and a record low of $151.30 billion in the 4th quarter of 2002.

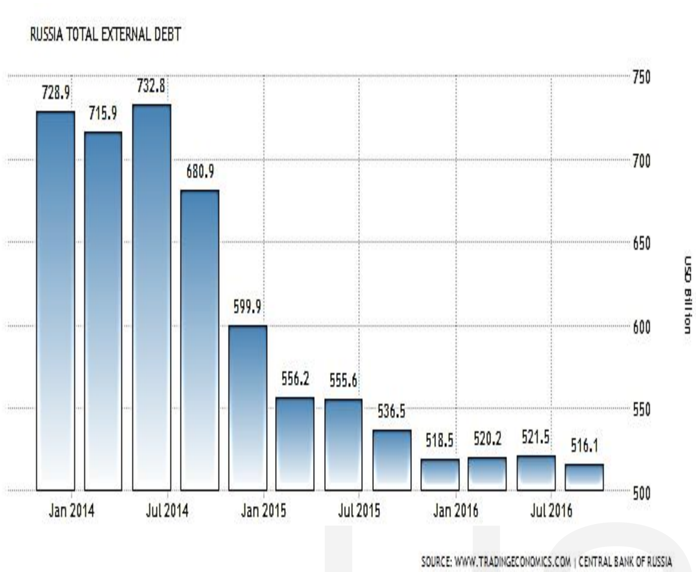

Fig. 3 Source: www.tradingeconomics.com Central Bank of Russia.

6. Global competitiveness

The Russian Federation moved eight places up to 45th position. This is indeed a significant improvement bearing in mind their previous position. Albeit this was explained mostly by a major revision of purchasing power parity estimates by the IMF, which led to a 40% increase in Russia's GDP when valued at PPP. In addition to that, the country improved on some market efficiency aspects, such as the regulatory business environment and domestic competition where they occupied the 96th spot. This mirrors the Russian government's tireless efforts to improve domestic conditions for doing business as well as support financial institutions with special low interest loans so as to boost their buoyancy. Meanwhile, 32 import tariffs have been significantly reduced as an effect of Russian's ascension to the World Trade Organization in 2012.

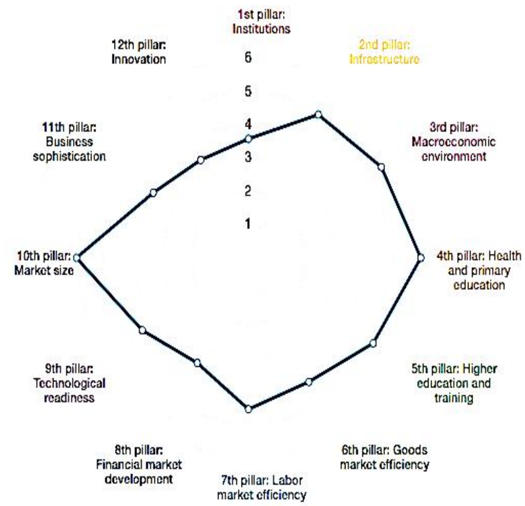

Fig. Source:reports.weforum.org/global-competitiveness-report-2005

7. Conclusion:

Based on our findings, there are two interesting scenarios that propped up. Not only did the sanctions have a negative effect on the Russian Economy, it also led to corresponding positive effects for the economy in general. There were numerous negative effects which reflected the implementation of the sanctions. However, due to specific reasons, we decided to focus on the more significant ones. The researchers identified the following negative effects as a result of the direct impact of the sanctions. They include:

i. Rising inflation levels
ii. Decline in both exports and imports
iii. Increasing external debt and low foreign direct investment
iv. Erratic trade flows and loss of market share

Meanwhile, apart from the negative effects of the sanctions, the Russian government managed to come up with counter measures which led to a mitigation of the full impact of the sanctions. The positive effects we identified are as follows:

i. The sanctions are generally assessed to have helped mitigate the macro economic challenges the Russian Economy was already facing, notably the rapid and pronounced fall in oil prices that started in the last months of 2014.
ii. The Russian Federation improved eight places to 45th position in the Global Competitiveness ranking report 2016, despite the sanctions in place. This indicates that the Russian government through its counter sanction strategy was able to respond accordingly to mitigate the full impact of the sanctions.

International Journal of Scientific & Engineering Research, Volume 8, Issue 4, April-2017
ISSN 2229-5518

8. Managerial Implication

The pessimistic outlook of the economy compounded by weakening domestic demand, weak and some redundant institutions and by ex tension the climate of uncertainty regarding future prices for mineral and natural resources, the Russian government needs to focus on the following steps below:

i. They need to tackle and address structural weaknesses in their Institutions as well as ensuring their operational independence.
ii. To develop and promote a vibrant financial market where all the stakeholders or players would be free to pursue their strategies within the spirit of competition.
iii. To reform and reorganize the commodity market thereby increasing its efficiency and vitality.

Moreover, if the government of Russia follows the points highlighted above, these would indeed serve as a recipe to achieve higher prosperity, coupled with socio economic development beyond the current downturn, as well as other economies in the region with whom they are strongly connected.

References

1. Gurvich, E. & Prilepskiy, I. (2015) "The impact of financial sanctions on the Russian economy". *Russian Journal of Economics. Vol. 1, Issue 4.*
2. Shirov, A. Yantovskiy, A & Potapenko, V. (2015) "Estimation of potential impact of sanctions on the economic development of Russia and the EU"*. Russian Academy of Sciences, Institute of Economic Forecasting.*
3. Sinyakov, A., Roitman, A. & Seleznyov, S. (2015) "Dynamics of Russia's potential GDP after the oil shock": The role of large change in relative prices and structural rigidities. *Voprosy Ekonomiki*
4. Ulyukaev, A. & Mau, V. (2015) "From economic crises to economic growth, or how to prevent the crisis from turning into stagnation". https://ideas.repec.org/a/nos/voprec/2015-04-1.html
5. Gros, D. & Mustilli, F. (2015) "The Economic Impact of Sanctions against Russia": Much ado about very little. CEPS (www.ceps.eu).
6. CIA World Fact Book (2016). https://www.cia.gov/library/publications/the-world-factbook/docs/whatsnew.html
7. Bond, I., Odendahl, C. & Rankin, J. (2015) "The Politics and Economics of sanctions against Russia.
8. https://www.cer.org.uk/sites/default/files/publications/attachments/pdf/2015/frozen_sanctions-10787.pdf *Retrieved on the 14/10/2016.*
9. CIA World Fact Book. *http://www.indexmundi.com/russia/economy_overview.html Retrieved on the 8/10/2016.*
10. World Bank, 2016; IBRD-IDA Report on the Russian Federation. *http://www.worldbank.org/en/country/russia/overview Retrived on the 12/10/2016*
11. World Economic Forum (2015) Global Competitiveness Report, *http://reports.weforum.org/global-competitiveness-report-2015-2016/economies/#economy=RUS Retrieved on the 12/10/2016*