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SEE ENERGY BRIEF

Monthly Analysis

Are EU Sanctions Against Russia Working?

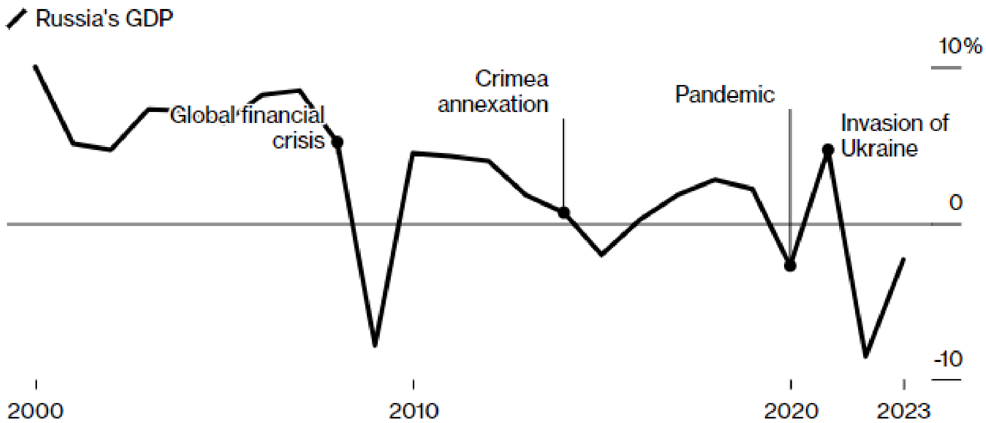
Introduction

The United States, the European Commission and their allies imposed unprecedented economic sanctions on Russia in the wake of its full-scale invasion of Ukraine, starting on February 24, 2022. The swiftness and intensity of the penalties initially crashed the ruble, forced the Russian stock market to close, and sent Russians to line up at ATMs to withdraw dollars from their bank accounts. The Russian economy was in free fall. Until it wasn't, exactly.

The country's central bank responded by sharply hiking interest rates to 20% **(1)** and imposing strict capital controls. Those interventions, along with Russia's still-intact ability to sell its oil and gas abroad, helped create a buffer against the economic chaos after the initial sanctions' shock. The economic crisis playbook did its job, and calmed the immediate crisis. The ruble stabilized. That allowed Russia to declare victory over the sanctions onslaught. "The strategy of the economic blitz has failed," Russian President Vladimir Putin said in April. **(2)**

At least, that is what Russia appeared to claim. Russia's efforts to shore up its currency mask the profound economic disruptions and transformations that sanctions are unleashing within Russia right now. The West's sanctions are aiming to completely isolate Russia from the rest of the world in terms of trade and finance. Cutting it off from key imports that it needs for commercial goods and its own manufacturing to make its economy work. That means high-tech imports like microchips, to develop advanced weaponry, but it also means buttons for shirts. However, as we are already in the fourth month of mounting sanctions, it is unclear to what degree the sanctions have managed to damage Russia's economy.

Figure 1: Deep contraction of Russia's GDP



Sources: Federal Statistics Service, IMF forecast for 2022-2023, Bloomberg

Whatever the case may be, Russia today is facing a deep recession, one the Bank of Russia says will be "of a transformational, structural nature" **(3)**. The Finance Ministry has predicted the Russian GDP will shrink by about 8.8% in its base case scenario in 2022 or by 12.4% under a more conservative scenario **(4)**. Inflation is expected to clock in as high as 23% this year. Russia is looking at a looming debt default. All of this will mean hardship for ordinary Russians, who are already seeing their real incomes shrink. Some tens of thousands have tried to flee the country, especially those in tech firms and services, prompting a potential "brain drain." And these are the things we know; Russia will cease publishing a lot of economic data, a tactic, experts said, Moscow has used before to obscure the effects of sanctions.

The US and European allies have continued to pile on more penalties, refining and sharpening the sanctions, all in an effort to ratchet up the pressure on Moscow. The EU has proposed a phase-out of Russian oil products, and depending on the final details, that might further erode the Kremlin's lifeline. And the US could take additional steps, like threatening secondary sanctions that go after countries like China or India, to deter them from buying cheap Russian energy. That comes at a cost, and not just for Russia. Even without more escalation, the sanctions regime against Russia is one of the most aggressive in history, untested on an economy of Russia's size and as entangled in the global financial system.

Whether the sanctions are "working", then depends on what they are intended to achieve. One thing is clear. Over time, these sanctions will likely make it harder for Russia to rebuild its tanks, manufacture cruise missiles, and finance a war. It will also make it harder to produce food and make cars. And it still may not stop Russia from pursuing its campaign against Ukraine, all with unpredictable consequences for the rest of the world.

What Russia Did to Deal With the Sanctions Shock

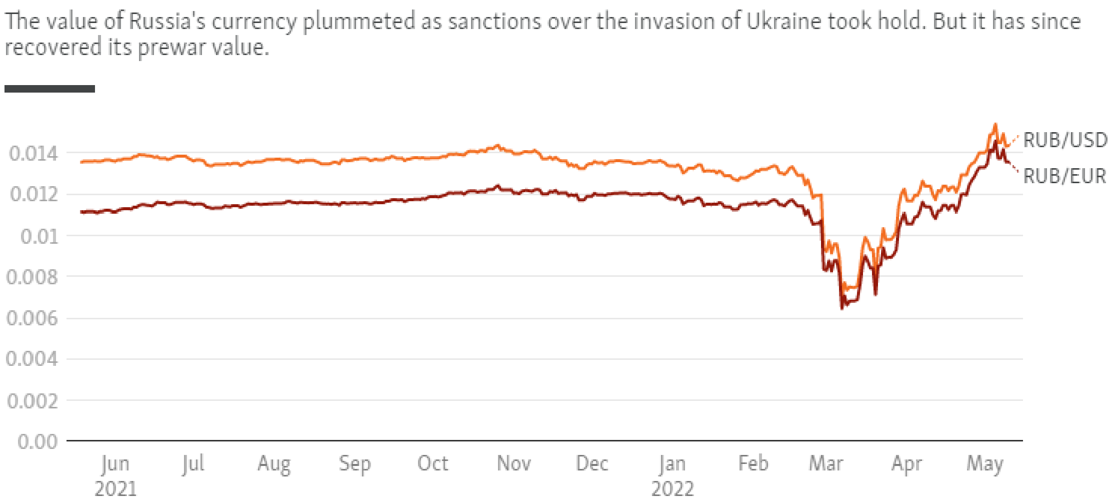
At the very start, early in 2022, the US and the European Commission threatened sanctions against Russia should it invade Ukraine. It was always a question of how far the West might go, largely because of concerns on how some of the pain might rebound, economically and politically, onto the US and its allies. But the West moved swiftly and more forcefully than many expected, a reaction to the brutality of Moscow's assault, the ferocity of Ukraine's resistance, and Ukrainian President Volodymyr Zelenskyy's pointed pleas.

After the US and EU put targeted sanctions on Russia in 2014 after its Crimea annexation and Donbas invasion, the Russian government took measures to sanction-proof-ish its economy — like building up some $640 billion in gold and foreign reserves **(5)**. Yet the intensity of these latest Ukraine sanctions rattled Russia's "fortress" economy. And in some cases, the West's measures directly targeted Russia's backup plan; sanctions on Russia's central bank, for example, prevented Russia from accessing about half of those foreign reserves. **(6)**

Even so, Russia reacted rather aggressively once those sanctions hit. Take the ruble, which President Joe Biden declared reduced to "rubble". In the aftermath of sanctions, its value crashed. It suddenly took a lot more rubles to buy, say, one US dollar. You really wouldn't want rubles, then, because you wouldn't have as much purchasing power. So, the Russian central bank sought to create demand for rubles.

The central bank did so through a series of measures. That included raising interest rates, an incentive for Russians to save their money. The bank implemented a series of capital controls that targeted Russian businesses and individuals. For instance, companies that export things or do business abroad had to convert 80% of their foreign exchange revenues to rubles **(7)**. It also limited the amount of money Russians could transfer abroad or remove from foreign bank accounts — currently no more than $10,000 over the next six months.

Figure 2: The Russian Ruble's rollercoaster ride



Source: exchangerate.host

Those are policies the Russian central bank engineered, but Russia has also benefited from the fact that it is still exporting a lot of oil and gas, mainly to India, China and other Asian countries, but also to several countries in Europe (e.g. Italy, Germany and France), which gets more than one-third of its natural gas imports from Russia. That money — hundreds of millions per day from the European Union alone — is coming into the Kremlin's coffers, and its ability to replenish funds gives the economy a cushion.

Seen in a broader context, the West, in fact, is caught in a trap. The sanctions and the deepening conflict are helping to raise global commodity and energy prices and this translates into higher revenues for Moscow in spite of a significant decrease in its volume of exports. And the higher international prices, by fueling inflation, mean political trouble at home for those behind the sanctions, e.g. gasoil in the US market now selling on average above $5.0 per US gallon, the highest ever.

This is partly why President Putin started demanding “unfriendly countries” to pay for natural gas in rubles, as it would help prop up Russia’s currency. But it’s also why, until his shutoff to Finland, Poland and Bulgaria, Putin wasn’t enforcing it because it might require contract renegotiations, and that might incentivize EU countries to start the process of weaning themselves off Russian hydrocarbons altogether. These measures are painful, which makes them harder to sustain. Russia has slightly eased some of its interventions, inching down interest rates to a (still high) 14% **(8)**. It also loosened some capital controls, but that also knocked the value of the ruble.

Oil and gas revenues help, but if sanctions against energy tighten, as with the EU’s proposal for a gradual oil ban, or Russia is forced to sell its gas on the cheap — or if the threat of running afoul of sanctions deters even the bargain hunters — the safety net frays over time. Russia has already said oil output is expected to decline as sanctions hinder investments and trade, which the IEA in its latest Oil Market Report of June 2022 estimates that it fall by 850,000 barrels per day or 7.5% since before the invasion of Ukraine.

Are Sanctions Against Russia Working?

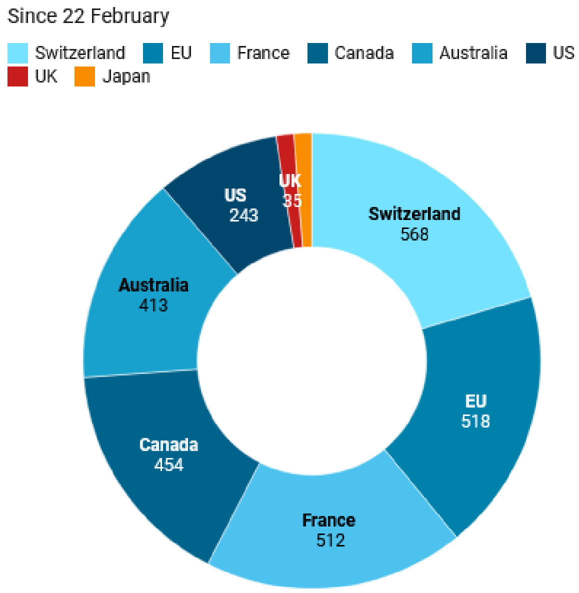
The longer sanctions stay in place, the worse it will be for them to be effective. Russia may figure out how to navigate as a permanently state-sanctioned economy — like Iran or North Korea. Russia will find workarounds where it can. It will substitute for supply chains, many of which will be murky, and thus help fuel a dark economy. Living standards may erode to levels not seen in decades, and the things Russians buy may be more poorly made and harder to get. In that respect, one can only observe that Russian people are known for their great resilience to adverse circumstances and as more pundits suggest the current situation will provide one more hardship test, but not as severe as in the past.

However, living standards will not deteriorate sharply in the immediate future, but it is the negative course Russia is on, for as long as the West keeps it there. Hence, the question is: What does the West actually want to achieve by imposing such harsh sanctions? Before the invasion, the Biden administration framed the threat of sanctions as a way to deter Russia from invading Ukraine. It did not succeed. In the wake of the invasion, the goal was re-framed as “inflicting pain on Russia and supporting the people of Ukraine,” which is how Biden put it in his State of the Union address. He also talked about depleting Russia’s military, making it harder to wage war in the future.

The Biden administration has also indicated that certain sanctions are trying to squeeze Russia, eroding its ability to finance its war in Ukraine. This month, Defense Secretary Lloyd Austin said that the US “wants to see Russia weakened to the degree that it can’t do the kinds of things that it has done in invading Ukraine”

(9). The administration hopes to accomplish that through a combination of sanctions on Russia and aid for Ukraine.

Figure 3: Who sanctioned Russia



Source: European Commission

But it is becoming increasingly less clear what a "weakened" Russia means, and what the United States and its allies would do with it. Are they using the pressure to get Russia to the negotiating table? Are they trying to stop the war by getting Russia to withdraw or surrender? Or to defeat it? And what will the consequences of that be?

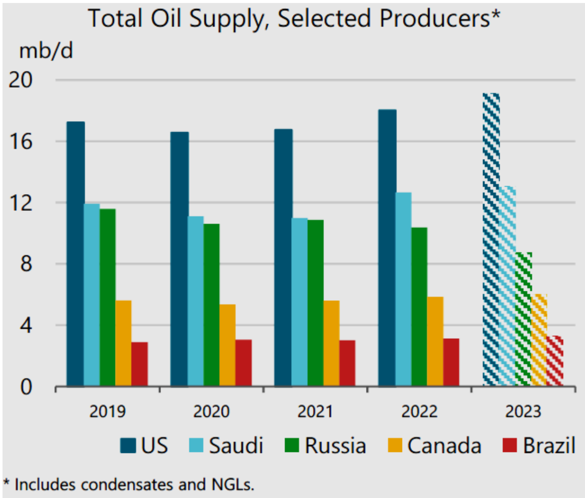
If this is an indefinite effort to weaken Russia, it may get harder to keep up the intensity. The US and its allies acted in cohesion and got enormous buy-in from other partners, including those in Asia. But as the war drags on and sanctions continue, that coalition may fracture, especially if the economic costs mount beyond Russia's borders.

We should bear in mind that poorer countries will also experience the shock of these economic sanctions, without having much say at all in whether or not they will support these policies. Farmers in Brazil need fertilizer from Russia, countries that depend on Russian arms exports all of a sudden won't have parts or equipment for themselves, either.

As experts said, the United States and its allies may also need to mitigate the pain for these countries, promising to help replace arms at a discount or offer food aid. The US's latest request to Congress for $33 billion in supplemental aid to Ukraine partially acknowledged this, including funding for global food assistance. There is no doubt that sanctions on Russia are unraveling its economy. But this act of extreme economic pressure is bound to have grave consequences beyond Russia. "It's a form of economic war," Saravalle said. "But it's also very much like we're reshaping the global economy". **(10)**

Meanwhile, as the IEA notes in its latest Oil Market Outlook, "the outlook for Russian oil exports remains mired in uncertainty and may continue to surprise. After plunging 930 kb/d in April, total oil production in May actually rose by 130 kb/d to 10.55 mb/d as crude oil exports to world markets were reallocated from traditional buyers adhering to new sanctions or shunning barrels voluntarily in solidarity with Ukraine. Even with a large swathe of Russian oil output hit by sanctions and embargoes, the country will easily retain its rank as the world's third-largest oil producer behind the US and Saudi Arabia. But the top two producers are expected to post annual record-high output both this year and next, widening the gap between them and Russia. Canada and Brazil are also poised to reach their highest ever levels for two years running". The IEA's Oil Market Report of March 2022 identified the potential for a shut-in of 2.5 million barrels a day of Russian oil exports starting from April; but losses could increase should restrictions or public condemnation escalate **(11)**

Figure 4: Total oil supply, selected producers



Source: IEA's Oil Market Report (June 2022)

Is a Punitive Tariff on All Russian Energy Imports a Better Choice Than a Gradually Phased-In Embargo on Selected Fuels?

The European Union's plan to target Russian oil, as it is exemplified in the 6^{th} series of sanctions, makes sense as a way to step up pressure on Moscow. Oil is a major source of hard currency for Russia, and since the introduction of financial sanctions has become a vital lifeline for the Russian economy and a crucial funding source for the war. The European Union agreed to an embargo on most Russian oil imports after late-night talks at a summit in Brussels on May 31, 2022. The president of the European Council, Charles Michel, hailed the deal as a “remarkable achievement”, after tweeting on Monday night that sanctions will immediately impact 75% of Russian oil imports, “cutting a huge source of financing for its war machine”. **(12)**

According to a recent analysis prepared by Bruegel **(13)**, this is far from the best option. Reducing purchases of Russian oil to zero over time might leave Russian revenues high while implying several negative short- and long-term consequences for the EU. Paradoxically, such an embargo might even result in a win for Russia, at least in the short-term, and a loss for the EU and the world’s economy overall.

Timing

The biggest flaw of the plan currently under discussion is that during the transition phase, oil prices in Europe and across the world could increase further in anticipation of reduced Russian exports. This trend started already at the end of April, when oil settled higher because of the increased likelihood of an EU embargo. Higher prices cause pain in importing countries. What is worse, they might even overcompensate Russia for the gradual loss of volumes. Given the dynamic of the war, such short-term developments might matter politically in Russia, where the government budget is funded by such revenues. A second timing issue is that the gradual phase-in would also give Russia time to develop new oil exporting strategies, rendering the embargo less effective.

Coverage

Banning imports of Russian crude might be straightforward, but banning imports of already in short supply diesel from Russia might be much more difficult. Given that oil products are partly substitutes, tighter crude supply would increase their prices as well, possibly leading to overcompensation of the Russian volume losses.

Retaliation

The third problem of the applied oil embargo is the risk that Moscow might retaliate by cutting off natural gas supplies to the EU. The recent shut-offs of supplies to Poland and Bulgaria show that this possibility should not be dismissed. And while the EU in any case needs to stand ready to be cut off gas, a full embargo may increase the likelihood thereof. In summary, a balanced and long-term embargo schedule might be much less useful politically than currently believed in many policy circles.

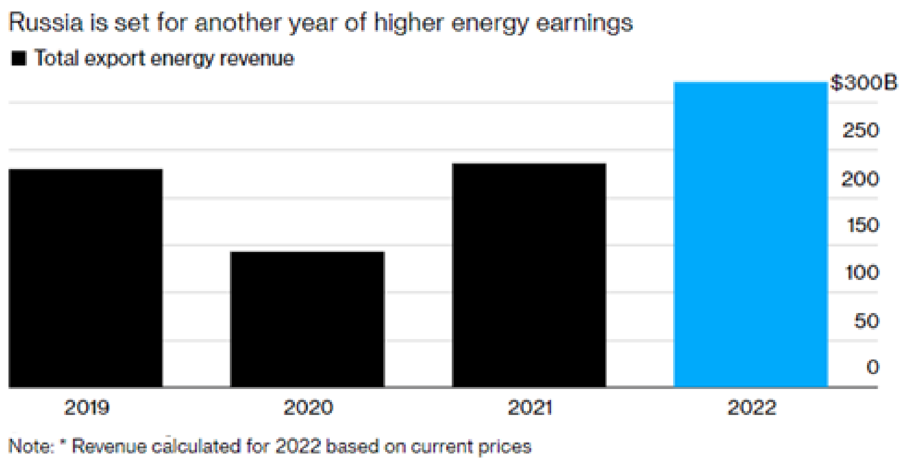
Alternatives

Instead, a better alternative would be a more flexible tool that can increase/reduce the pressure on Russia depending on the situation in Ukraine. A punitive tariff on all Russian exports of crude oil, oil products and natural gas would tackle all the issues we have raised for a full embargo. It would immediately reduce Russian revenues. However, Russia would still have an incentive to export to Western buyers and would therefore be unlikely to quickly build new infrastructure to export fossil fuel to third countries. A tariff could also be adjusted depending on political developments. A punitive tariff on all energy imports from Russia would be a better choice than a gradually phased-in embargo on selected fuels.

Discussion

Sanctions historically have worked better against small, vulnerable states than large or powerful ones. But they have rarely produced timely change. The current Western sanctions against Russia could take years to seriously hurt its economy. It is worth noting that Bloomberg Economics expects Russia will earn nearly $321 billion from energy exports this year, an increase of more than a third from 2021 **(14)**. Thus, despite US and European sanctions, Russia's revenues from its energy exports are expected to increase in 2022, due to rising energy prices.

Figure 5: Dollar lifeline



Source: Bloomberg Economics

The irony is that, despite employing all possible coercive economic instruments against Russia and making it difficult to negotiate an end to the war, the Biden White House does not believe that sanctions alone will work, which explains why it has increasingly turned to weapons supply and contemplates a lengthy military engagement in the field, including asking Congress for a staggering $33 billion in additional military and economic funds to fuel the conflict and stymie Russian war objectives.

The introduction of widespread sanctions is signaling the advent of a new era of US-led unilateralism, which is likely to weaken and ultimately even undermine the Western-controlled global financial architecture that they are meant to defend. The sweeping sanctions, by spurring broader concerns about the weaponization of finance and its implications for any country that dared to cross a US red line, have created a new incentive for non-Western states to explore establishing parallel trade arrangements. China will not only lead this process but is also likely to emerge as the real winner of the NATO-Russia conflict.

Biden's belief that "this war could continue for a long time" is backed by the Chairman of the Joint Chiefs of Staff General Mark Milley, who testified that he expects it to last years. But as the conflict drags on and the boomerang effects of the sanctions deepen the cost-of-living crisis, the divides in the Western camp will widen and "Ukraine fatigue" will inevitably set in. The West will be left with little choice but to negotiate with Putin to end the conflict, as predicted by Javier Solana, a former NATO chief who also served as Spain's foreign minister. Such negotiations will be vital to halt Ukraine's destruction and avert Europe from paying a huge price as a result of much increased energy cost. **(15)**

In parallel, the US is urging European capitals to seek ways of easing the impact of their ban on insuring Russian oil cargoes, arguing the measure could cause global crude prices to soar. The EU and UK agreed to prohibit insurance on tankers carrying Russian oil at the end of last month, in one of the most far-reaching sanctions yet imposed in response to the war launched by President Vladimir Putin in Ukraine. The EU has now put its ban into law, subject to a delay before it comes into force, and officials play down the idea that it can be adjusted. The UK, which agreed to mirror Brussels' insurance prohibition, has yet to lay out its own measures. **(16)**

Now, anxiety is taking hold in Washington as it reflects fears that the measure could make it impossible for many oil tankers to transport Russian crude, given the dominance of the European insurance industry. Now, the US is trying to dilute sanctions by working on ways to ensure the ban does not drive crude prices even higher. But proposals to allow cover for cargoes priced below an agreed cap or impose tariffs on oil imports do not have broad support in European capitals. This latest development is most didactic and revealing on the usefulness of sanctions, other than political grandstanding, in actually economically punishing the culprit nation and enforcing it to capitulate.

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