The empire strikes back
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The Empire Strikes Back: Economic Statecraft and the Securitisation of Political Economy in Russia

Introduction

Economic statecraft has been the primary tool used by Western powers and their allies in response to Russian involvement in the conflict in Ukraine. The term economic statecraft refers to a range of measures, including travel bans on individuals, asset freezes, trade embargoes, financial restrictions and other economic sanctions. The objective of economic statecraft is not always clear; while effecting a change in the target country’s foreign policy behavior is desirable and the ostensible objective of statecraft, in reality policy makers from sender countries often realise that the aims of statecraft should be more limited. Imposing a cost on the target country to signal displeasure with its policies, for example, is a more limited objective. Imposing such a cost might then deter the target country from escalating its objectionable (in the eyes of the sender countries) behaviour.

1 The author would like to thank Julian Cooper, Philip Hanson and Silvana Malle for comments made on previous iterations of this article. In addition, the insightful comments provided by two anonymous reviewers are gratefully acknowledged. Lucy Buckland also provided helpful research assistance. The usual disclaimers apply.

2 For a broad discussion of economic statecraft, see Baldwin 1985; and for a discussion of the West’s use of economic statecraft in relation to the Soviet Union during the Cold War, see Hanson 1988.

3 The terminology of the statecraft literature refers to the country or countries imposing economic measures as ‘sender’ countries, while the country (or countries) that is the object of statecraft is described as the ‘target’ country.
In the context of the Ukraine conflict, the stated aims of Western economic statecraft are multiple. For example, certain measures were imposed in response to Russia’s annexation of Crimea in March 2014. Later, wider ranging measures (so-called sectoral sanctions) were imposed because of Russia’s involvement in the conflict in south-eastern Ukraine. What is common to all these measures is a desire by the Western sender countries to impose a cost on the actions of the target country, Russia. These costs may then, at the very least, send a clear signal that Western countries are unhappy with Russia’s actions in Ukraine, or possibly even deter Russia from escalating its activities. It is also possible, at least in theory, that if the costs of economic statecraft to Russia are sufficiently high, it might be persuaded to modify or reverse its policies towards Ukraine.

The focus of this article is on assessing the costs imposed by Western economic statecraft on the Russian economy. The purpose of the article is not to determine whether economic statecraft has achieved its political objectives – whether they are signalling deterrence or a demand for modification of Russia’s foreign policy. While the economic impact and the effectiveness of economic statecraft are treated as analytically distinct, it is nevertheless true in practice that the magnitude of the costs imposed by economic statecraft is an important component in determining whether it will be effective as an instrument of foreign policy. After all, if the costs for the target country are modest, it is possible that the effectiveness of economic statecraft might be correspondingly low. In addition to assessing the costs of economic statecraft, this article will also consider the Russian policy response and the impact that this response has exerted upon domestic political economy in Russia.

To address these two questions, the article is organised as follows. The first section provides an assessment of the impact of Western economic statecraft on the performance of the Russian economy between March 2014 and spring 2015. This is done by first examining the importance of other conjunctural factors that also shaped the performance of the Russian economy during the period under examination, and then considering the direct and indirect effects of sanctions. It is argued that while some aspects of Western statecraft clearly imposed a significant cost to Russia -- especially sanctions directed at the financial sector – the impact of the falling price of oil and the pre-existing slowdown in the economy complicate any attempt at
explaining the sources of Russia’s poor economic performance. Assessing the precise impact of economic statecraft is therefore extremely difficult. The second section considers the impact that Western statecraft has exerted on domestic political economy in Russia. Here, it is argued that the Russian domestic policy response to the use of economic statecraft has thus far been consistent with the behaviour of many other countries that have been targeted by similar measures in the past. Perhaps the most important observation is that the system of political economy is becoming increasingly securitised, in other words defined by national security concerns rather than the demands of economic development. A third and final section concludes the argument.

The Impact of Economic Statecraft on Russian Economic Performance

There are a range of estimates of the economic impact of Western statecraft imposed in the aftermath of Russia’s annexation of Crimea and military involvement in Ukraine. In November 2014, the Finance Minister, Anton Siluanov, suggested that sanctions had cost Russia $40bn. In April 2015, President Putin stated that sanctions have cost Russia $160 billion (Latukhina 2015). Outside Russia, numerous politicians have assigned great importance to the impact of sanctions on the functioning and performance of the Russian economy during what turned out to be a very turbulent period.  

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However, estimating the impact of economic sanctions on the Russian economy since March 2014 is fraught with even more difficulty than is normal when carrying out such estimates. In addition to the methodological challenges inherent to any such exercise under even ‘normal’ conditions, the performance of the Russian economy in the year subsequent to the imposition of sanctions was also affected by additional conjunctural, and therefore complicating, factors.

First, Russia was already in the grip of an economic slowdown that saw the country drift towards stagnation even before the imposition of sanctions. This slowdown was structural in nature and has been exerting a negative effect on a number of key economic indicators. Second, the dramatic decline in oil prices over the second half of 2014 was of profound importance to an economy that was, in 2013, the world’s second largest producer and exporter of oil, and that relies on receipts from oil exports to provide around half of Federal government revenue.  

Consequently, disentangling the impact of statecraft from the other two, arguably more important, forces buffeting the Russian economy is near impossible. Healthy scepticism should therefore be exercised when presented with suspiciously precise estimates of the economic impact of Western statecraft. Rather than seeking to identify a precise cost to the Russian economy (in dollar terms, for example), it is perhaps more useful to examine how economic statecraft may have affected the economy in a step-wise fashion, assessing first the ‘direct’ impact on the targeted sectors of the economy, and then the less obvious ‘indirect’ impact that statecraft may have exerted on the functioning of the wider economy. Before doing so, however, it is first necessary to sketch out the importance of the economic context in which statecraft was imposed.

*Context matters: slowing economic growth and the collapse in the price of oil*

A truly accurate assessment of the macroeconomic impact of statecraft would require that the *ceteris paribus* condition be satisfied. However, in 2014-2015, all other things

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6 BP (2014). In 2013, Russia produced an average of 10.3 million barrels per day (bpd). This compared to 11.5 million bpd in Saudi Arabia and 10 million in the USA.
in the Russian economy were far from equal. It is important to be aware of two highly significant factors that influenced the performance of the Russian economy at the time that sanctions were imposed.

First, Russia’s economic performance had been weakening for several years. This is likely due to the exhaustion of the economic growth model that served Russia well between 1999 and 2008.³ As illustrated in Figure 1, annual real GDP growth was estimated to have slowed to just 0.6% in 2014, down from around 4% in 2012 and considerably slower than the 1999–2007 average of over 7%. This slowdown was likely caused by a combination of many factors, among which the most important were a shrinking labour force, the slowdown in government and consumer spending and, perhaps most importantly, a low share of investment in economic activity (see Connolly 2011; Gaddy and Ickes 2014).

The second factor to note is the sharp decline in the price of oil which began in the second half of 2014 and continued into 2015. The average price for Urals crude oil hovered around $110 per barrel from 2011 to June 2014. Prices then plummeted to $47 per barrel at the end of January 2015. This resulted in a sharp decline in export revenues and tax receipts despite the fact that the volume of oil production in Russia reached a post-Soviet record level in 2014. Although oil prices later recovered somewhat in the first half of 2015 – Urals crude was trading at around $65 per barrel in mid-May 2015 – they fell again to below $40 per barrel in December 2015.

³ Essentially, this model was based on the redistribution of fast-growing natural resource revenues to other parts of the economy. See Kudrin and Gurvich 2014; Zamarayev, Kiiutsevankaia, Nazarova and Sukhano 2013; Mau 2014; Mau 2013; Connolly 2015; World Bank 2015. On the wider regional slowdown, see Prochniak 2011.
The simultaneous structural slowdown in economic growth in Russia and the decline in the price of oil make it difficult to isolate the economic impact of sanctions. To illustrate this point consider first the influence of the structural slowdown on economic performance. A large number of economic forecasts made immediately before the imposition of the first round of sanctions in late March 2014, or just after, predicted that annual GDP growth in 2014 would be very low (Table 1). Yet the economy defied the expectations of the majority of forecasters and grew by an estimated 0.6% on an annual basis. All of these forecasts were unanimous in citing domestic factors, such as weak investment, as the primary drivers of weak performance. They did not take sanctions into account. If these forecasts had been made with the knowledge that a range of significant economic sanctions would be imposed, or indeed that the price of oil would fall by around 50%, it is likely that the forecasts would have been even more pessimistic.

The Russian economy certainly did not perform well in 2014. But nor did it perform any worse than it was expected to, and, if anything, slightly surpassed pre-sanctions expectations. This does not necessarily mean that the imposition of sanctions acted as a boost to the Russian economy (or to put it differently, that sanctions were a net benefit to the economy). Rather, what it does suggest is: (a) that the initial negative economic impact of sanctions may have been modest; and (b) that some other factor that forecasters had not predicted may explain why the Russian economy performed slightly better than it was expected to.

It is likely that the other factor explaining Russia’s economic performance was related to the sharp depreciation of the ruble that occurred over the course of 2014. Some commentators have suggested that this depreciation was caused at least partially by sanctions. It is, for example, intuitively appealing to suggest that sanctions may have led to a loss of business confidence in Russia, which in turn caused a rise in capital outflows, generating downward pressure on the exchange rate. However, closer inspection of the data reveals that daily movements in the price of oil act as a more reliable predictor of ruble-dollar exchange rate movements: between January 2013

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8 It should be noted that any conclusions derived from comparing actual performance with forecasts should be treated with caution. After all, the economic forecasts may not have been accurate in the first place.
and May 2015, the correlation in movements between the two was almost perfect (Figure 2).  

Thus, the single best explanation for the deprecation of the ruble was the decline in oil prices. Most analysts did not expect the sudden and sharp decline in oil prices, and if it had been anticipated, they would probably have predicted dire consequences for the Russian economy. However, the impact on the Russian economy was mixed. On the one hand, the value of total exports, dominated by hydrocarbon sales, plummeted with a corresponding depreciation of the ruble. On the other hand, ruble depreciation helped cushion federal tax revenues from the fall in the price of oil. Russia’s dollar-denominated oil revenues – which historically account for around half of total federal income – bought more rubles than they did in 2013. Consequently, Russia actually registered a modest federal budget surplus in 2014 (Ministry of Finance of the Russian Federation 2014).

Depreciation also raised the price of imported goods and services, resulting in a sharp decline in the value of imports. However, the weak currency also appeared to have boosted domestic production of goods and services through the import substitution effect. In simple terms, as the price of imported goods rose, Russian consumers and businesses switched to homemade substitutes. As is illustrated below, the impact of the weak ruble may well have cushioned the Russian economy from both the home-grown slowdown and the imposition of sanctions.

To sum up so far: the simultaneous nature of the shocks affecting economic performance in Russia over the course of 2014-2015 was highly significant from an analytical point of view. No single factor from the structural slowdown - the fall in oil prices or the imposition of sanctions -, can solely explain economic performance over this period. Moreover, the interaction between each factor has resulted in some unexpected outcomes (such as the growth in GDP that exceeded most forecasts). It is therefore difficult to assign with any confidence a specific weight to the importance of

9 The Pearsons’ $r$ correlation coefficient is 0.96.
Western economic statecraft on Russian economic performance during the period under examination.

*Direct effects of Western statecraft on economic performance in Russia*¹⁰

If the overall macroeconomic impact of economic statecraft is difficult to discern, it is nevertheless plausible to argue that it may have affected the performance of targeted sectors. In addition to asset freezes and visa bans on Russian individuals, companies or other entities in Russia/Ukraine who are considered to be complicit in Russia’s actions in Ukraine, sanctions were targeted at three main sectors – energy, defence and finance. They included:

- a ban on trading bonds and equity and related brokering services for products whose maturity period exceeds 30 days with some of Russia’s largest state-controlled banks (including Sberbank and Gazprombank), three Russian energy companies (including Rosneft’, Transneft’, and Gazprom Neft’; although Gazprom was excluded from EU sanctions, it was subject to US sanctions), and numerous Russian defence companies (including United Aircraft Corporation, Uralvagonzavod and Almaz-Antei);
- restrictions on loans to five major Russian state-owned banks by EU countries: Sberbank; VTB; Gazprombank; Vneshekonombank (VEB); and Rosselkhozbank; with the US ban also including Bank of Moscow;
- an embargo on arms trade with Russia;
- a ban on exports of so-called dual-use items, i.e. civilian industrial goods that can be used as (or to produce) weapons systems; and
- a ban on the provision, exportation, or re-exportation of goods, services (not including financial services), or technology in support of exploration or exploitation of deepwater, Arctic offshore, or tight oil projects.

In response, Russia imposed countersanctions in August 2014, which resulted in a one-year ban on imports of fruit, vegetables, meat, fish, milk and dairy from a number of countries, including the EU, Japan and the USA. The initial impact of sanctions in each of these four sectors is discussed below.

¹⁰ Passages from this section borrow heavily from Connolly (2015b).
The defence industry

Defence industry production rose in 2014-2015, despite sanctions, due to growing demand from abroad (with India the largest foreign customer) and from a surge in domestic orders that was explained by the rise in armaments procurement. The arms embargo did affect some companies and high-profile projects within both Russia and the West. For example, France and Italy both had multi-billion dollar deals to supply Russian customers which were compromised by the imposition of sanctions. All future deals - and in the case of the French Mistral helicopter carrier, some past deals - were affected by the embargo. The aggregate effect of the arms embargo on Russia was, however, modest due to the fact that only a small proportion of Western arms exports go to Russia, and a correspondingly small proportion of Russian arms exports go to Western countries. As a result, despite the imposition of sanctions, Russia recorded well over $13 billion worth of arms exports in 2014 (Figure 3), making Russia the world’s second largest exporter of armaments.11

This robust export performance was achieved while domestic orders also rose to post-Soviet high levels. As part of the state armaments programme (gosudarstvennaya programma vooruzheniya, or GPV) to 2020, which aims to reequip and modernise Russia’s armed forces, military spending as measured by SIPRI rose from 3.2% of GDP in 2000, to 4.5% in 2014.12 Of this, half was spent on procurement and research and development (R&D). In 2015, military expenditure was expected to peak at 5.4%.

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12 All data on volume and composition of military expenditure are derived from Cooper 2015 (cited with permission of the author).
with 60.5% of this amount earmarked for procurement and R&D. Given the strength of external and domestic demand, there was little scope for further expansion of export deliveries due to domestic orders stretching the capacity of the Russian arms industry (oboronnyi-promyshlennyi kompleks, or OPK) to fulfil all the orders placed.

The OPK did, however, encounter some problems in implementing production orders because of the Ukraine crisis. Some of these problems emerged not only as a result of Western sanctions, but also because of severed links with Ukrainian defence industry enterprises that were previously closely integrated with the Russian defence-industrial production network. The Ukrainian ban on arms exports to Russia has, for example, caused shortages of helicopter engines and power supply units for naval ships. The impact of Western sanctions was observed in the form of reduced access to some individual components used within weapons systems rather than in final weapon systems. To address these weaknesses, the Russian defence industry and Military-Industrial Commission developed an import substitution plan to replace embargoed products with domestically-produced items. According to the deputy defence minister for armaments, Yurii Borisov, this import substitution plan for Ukrainian products should be fully implemented by 2017, although replacing Western components may take longer (see Naberezhnov 2014 and Mukhin 2015).

The hydrocarbons sector

The impact of sanctions on oil production over 2014-2015 was negligible, with post-Soviet record levels of oil production registered in 2014 (Figure 4). This is because Western sanctions target projects oriented to future rather than current production. This has been done by the imposition of restrictions on technologies related to Arctic

and deep-water exploration, as well as onshore tight oil extraction (for example, from the giant Bazhenov formation). The vast majority of Russia’s current oil production comes from onshore deposits in Western and Eastern Siberia, both of which continued to yield large volumes of hydrocarbons (IEA, 2014, p. 147). However, as illustrated in Figure 4, production from existing ‘brownfield’ deposits is expected to decline over the next decade. Unless massive investment in ‘greenfield’ deposits is undertaken -- especially in the offshore deep-water, Arctic and tight oil deposits targeted by sanctions -- declining production may not be replaced. As a result, sanctions should only be expected to affect Russian oil production over the medium term (i.e. 3-5 years).

<Insert Figure 4>

While aggregate production remained unaffected by sanctions, a number of high profile joint projects with Western international oil companies (IOCs), such as Exxon-Mobil and Statoil, were disrupted.14 Perhaps the most high profile example is the joint venture between Rosneft’ and Exxon’s Kars Project to extract oil from the Kara Sea.15 Without Western IOC participation, Russian firms lacked the technological capability to exploit this or other similar deposits. While these projects are high profile, the short-term impact should not be exaggerated. For example, a spokesperson for the French IOC, Total, stated in May 2015 that sanctions prevented it from proceeding with only one project from its activities in Russia.16

14 A number of such joint ventures were formed in 2010-2011 to help Russian state-owned firms exploit technologically demanding and hard-to-reach deposits offshore and in the Arctic. See Overland, Godzimirski, Lunden and Fjaertoft 2013.


16 ‘Investitsii Total v RF ne byli zamorozheny, kompaniya prodolzhaty proyekty v strane’
As in the armaments industry, the Russian authorities developed a range of counter measures to prevent Western sanctions from constraining exploitation of technologically-demanding deposits. These included efforts to include equipment used for hydrocarbons extraction in the wider import substitution strategy, as well as to source such equipment from countries not involved in the sanctions regime, such as China (Barkov 2015). Elsewhere, Gazprom resorted to employing larger numbers of contractors to build smaller portions of the Power of Siberia pipeline in order to circumvent the constraints imposed by sanctions on the ability of Gazprom and several construction companies to acquire capital and technology (Sirov 2015).

While there was much uncertainty as to whether Russia could produce substitutes to a sufficiently high standard, early signs indicated that efforts to switch suppliers of imported equipment were bearing fruit. Trade data reveal that in 2014 imports of equipment used in oil and gas extraction (drilling and tunneling equipment, pumps, etc.) from Western countries involved in the sanctions regime fell by around 50%. By contrast, imports of similar equipment from China rose by 8%. This is even more noteworthy considering that total imports of such equipment fell by 24%, as the decline in oil prices caused oil producers to rein in investment (Yedovina 2015).

It is also worth noting that many consider the single biggest obstacle to future oil production in Russia to be the onerous tax regime currently in place. This is a claim made frequently by those in Russia’s energy industry, including even by the minister for natural resources, Sergei Donskoi, who recently asserted that Russia’s ‘imperfect’ taxation of the hydrocarbons sector is a bigger problem for the industry than Western

[Total has not frozen its investments in Russia, the company is continuing its projects in the country], Oil and Gas Information Agency, 20 May 2015, available at: http://www.angi.ru/news.shtml?oid=2825111, accessed 20 August 2015.

economic sanctions. It is thus possible, at least in principle, for Russian oil production to be maintained via changes to the taxation and regulatory system if it proves difficult to acquire substitutes for Western technology.

In addition to restrictions on acquiring equipment, many Russian energy producers have been blocked from accessing capital. This is important for two reasons. First, and as stated previously, continued production requires massive volumes of capital investment (Henderson 2015). Financial sanctions have created a clear mismatch between projected investment and availability of capital to fund it. Second, many Russian energy producers – not least the state-owned Rosneft’ and Gazprom – are highly leveraged, with high debt-revenue ratios, much of which is denominated in foreign currencies. Constrained in their ability to refinance existing stocks of debt, targeted Russian energy companies simply carried out scheduled repayments. Despite the decline in oil prices, foreign currency-denominated revenues, as well as existing cash assets, were used to finance these repayments. Some firms, such as Rosneft’, also tapped into public foreign currency reserves (such as those managed by the Central Bank). Perhaps in a sign of financial distress, Rosneft was rumoured to be considering opening credit lines with state-owned banks, as well as applying for access to the country’s sovereign wealth fund (NWF) (Mordyushenko and Melnikov 2015). It has also been suggested that Rosneft’ may sell a 19.7% share in the company to raise capital (Antonova 2015). Inevitably, high debt servicing costs have reduced the availability of capital to finance investment, although the low price of oil caused a retrenchment in capital investment across the global energy industry, and not just in Russia.


19 Several institutional changes have taken place, see “'Gazprom" obsuzhdayet s LUKOYLom vozmozhnost' raboty na uchastkakh shelf’ia’ [Gazprom and Lukoil discuss the possibility of working on shelf sites], RIA Novosti, 19 May 2015, available at: http://ria.ru/economy/20150519/1065301711.html#ixzz3aa6Lh33c, accessed 20 August 2015.
In the event that the existing sanctions regime is maintained, the key issue is whether Russia can successfully replace existing Western technology and finance, either domestically (through import substitution or the use of state financial resources) or from ‘friendly’ states (in the form of equipment or loans). In this respect, much will depend on Russian government economic policy. At the time of writing, it appears that the Russian government would proceed with import substitution plans irrespective of whether the sanctions regime is relaxed. This is because Russia’s leaders appeared to have come to the conclusion that Russia should insulate itself from the threat of further sanctions in the future. Not to do so would represent a threat to Russia’s national security, as stated after a meeting by the Russian National Security Council (Egorov 2015).20

*The financial sector*

Financial sanctions exerted perhaps the most observable influence over the Russian economy. Access to Western capital markets was effectively closed to a large number of Russian corporations, and not just those directly targeted by sanctions. Firms in sectors directly targeted by sanctions – such as those in the energy, defence and construction industries – suffered. But so did firms not directly sanctioned, due to a ‘contagion’ effect as lenders became reluctant to lend to Russian firms because of fears that sanctions may be extended in the future.

*<Insert Figure 5>*

This resulted in many Russian firms being forced to repay, rather than refinance, their external debt obligations, causing a significant rise in net private capital outflows and a reduction in the pool of capital available to fund investment in the wider economy (Figure 5). Indeed, the size of capital outflows in 2014 was more severe than the ‘sudden stop’ of capital inflows that accompanied the recession of 2008-09. Total non-financial corporate (which includes many large state enterprises, such as Rosneft’ and Gazprom) and financial sector external debt fell from around $715 billion in

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January 2014 to $597 billion at the end of 2014. The total stock of external debt has declined due to a combination of repayments (to Western banks), rescheduling of existing debt (to banks or other corporate entities that either own or are linked with the Russian debtors), or because of a reduction in the dollar value of ruble-denominated debt.

<Insert Figure 6>

The surge in private capital outflows, at least partially driven by external debt repayments, contributed to the reduction in Russia’s foreign exchange reserves (see Figure 6). It has been suggested that this threatened the financial stability of Russia because Russia’s international reserves were not liquid enough to be used to meet external financial obligations, and also because Russia’s foreign debt obligations in 2015 and 2016 exceeded the stock of reserves (Åslund 2014). However, upon closer examination, Russia’s financial position appeared to be reasonably stable.

First, Russian reserves, including gold, which is normally held by central banks to provide emergency liquidity assistance should foreign assets suddenly depreciate, and reserves assigned to the two sovereign wealth funds – the Reserve Fund and the National Wealth Fund – could be utilised by the authorities, if required. Indeed, it should be noted that the domestic spending obligations attached to the Reserve Fund and the National Wealth Fund are denominated in rubles. Consequently, domestic obligations could be met by simply instructing the Central Bank to print rubles to ‘purchase’ their holdings of foreign exchange reserves.

Second, Russia’s external debt obligations were (and continue to be) exaggerated by financial arrangements employed by Russian corporate groups, which resulted in a substantial volume of ‘intra-group’ debt. These debts to ‘parent’ companies by subsidiarises were much softer loans than those taken out from Western banks. Indeed, many corporate groups postponed payments on such debt over 2014-2015. These intra-group debts accounted for nearly a quarter of Russia’s total stock of external debt (i.e., around $133 billion at the end of 2014). Moreover, intra-group debt repayments accounted for a proportionately larger share of scheduled external debt payments over 2015 (55% of all scheduled repayments) and 2016 (42%). In addition,
Russian corporations also held significant cash reserves abroad (well over $100 billion in mid-2015).\textsuperscript{21}

Third, as a country that consistently runs a large surplus on the current account of its balance of payments, Russia was in a position to be able to generate annual flows of dollar income in the region of at least 2-3\% of GDP.

Thus, while it is clear that Russia was stretched by financial sanctions and saw the availability of capital dwindle, it possessed sufficient reserves, as well as the capacity to generate future earnings of foreign exchange, to ensure financial stability, at least in the short-term. The ostensibly large external debt liability was also exaggerated by intra-group financing arrangements. As a result, Russia probably passed the peak of external financing pressure in late 2014. Because increased access to capital from alternative sources (such as Asian capital markets) had not materialised, sanctioned Russian firms began to reorganise their finance arrangements over 2014-2015 so that they relied more on domestic (usually state-owned) banks for funding.\textsuperscript{22}

\textit{Agriculture}

The effects of Russian counter sanctions in the agricultural sector can be examined on the producer side (i.e. on Russian agricultural producers) and the consumer side (i.e. on the price and availability of food products to Russian consumers). Domestic producers of agricultural goods are seemingly well placed to benefit from the limitations imposed on Western producers. However, Russian producers tend to be weakest in those sectors where Western producers were most active, such as pork and beef products as well as specific categories of fruit and vegetables. As a result, domestic production did not rise as dramatically as some initially hoped. In 2014,

\textsuperscript{21} ‘External Sector Statistics’, \textit{Central Bank of the Russian Federation}, available at: 

\textsuperscript{22} ‘External Sector Statistics’, accessed 20 August 2015.
agricultural production grew by 3.7%.\textsuperscript{23} Thus, domestic production has expanded, but only modestly. Instead, trade data reveal that substitutes for European products have been found in third countries, such as Argentina, Belarus, Brazil, Chile, China and Turkey.\textsuperscript{24}

The reduction in imports from Western countries, and the costs associated with seeking new suppliers, resulted in food prices rising above the average rate of consumer price inflation (CPI). Again, it is difficult to separate the impact of the food embargo from the ruble depreciation that contributed to a wider rise in prices for all imported products (Figure 7). Food price inflation tended to affect those segments of society that consumed imported goods, that is, mainly the urban, middle classes. Poorer sections of Russian society were less affected for the simple reason that they tended to buy more domestically-produced products, although the price of domestically-produced food products also rose. It is also worth noting that historically it is not unusual for food prices to diverge from the headline rate of inflation in Russia.

\textbf{<Insert Figure 7>}

\textit{Indirect effects}

Sanctions may also have affected economic performance through indirect channels. For example, sanctions may have caused a diversion in the trade of certain goods or services, even if those goods or services were not explicitly sanctioned. For example, if there are expectations of future sanctions from certain countries, Russian firms may have sought to insulate themselves from any potential future disruptions by seeking


out new markets or suppliers. The threat of future sanctions may also result in a higher perception of risk to those firms economically active in Russia. This may result in a deterioration of the business environment that may deter investment.

**Impact on trade**

Russia’s trade with the world fell substantially in 2014. In 2014, exports amounted to $497.8 billion, down from $523.3 billion in the previous year (a drop of nearly 5%). Imports fell from $341.3 billion in 2013 to $308 billion in 2014 (a fall of 10%). Again, this decline in trade was largely driven by changes in the price of oil and the exchange rate.25

The composition of Russia’s foreign trade also shifted.26 The share of China in Russian exports rose from 6.7% in 2013 to 7.5% in 2014. However, total trade with the EU also rose. This included a decline in the EU’s share of total Russian imports (from 42.5% in 2013 to 41.4% in 2014). The food embargo undoubtedly contributed to this decline. Perhaps unexpectedly, given both sanctions and the decline in the price of oil, the EU’s share of total Russian exports rose from 45.7% to 52.2% in 2014. Thus, at this early stage, there was no evidence of a significant shift in trade from the EU to China. This demonstrates that caution should be applied when interpreting Russian official statements signalling a desire to ‘pivot’ away from economic integration with Western countries to non-Western countries. Any meaningful shift in the direction of Russia’s external economic relations is likely to take decades.

**Impact on investment**


At around 20% of GDP, investment in fixed capital in Russia is, by the standards of many other middle-income countries, comparatively low. It is certainly too low to generate economic diversification and modernisation (Connolly 2011; Gaddy and Ickes 2014). There has been a clear trend towards declining investment growth since 2010, with a sharp contraction in investment observed in the final quarter of 2014 (Figure 8). This was likely to have been caused by the drop in the oil price and the concomitant depreciation of the ruble.

<Insert Figure 8>

Around 30% of total fixed capital formation in Russia takes place in extractive industries (i.e. the extraction of metals and hydrocarbons). Consequently, when sentiment in that sector takes a turn for the worse – as it did in 2008-9 and again in the final quarter of 2014 – aggregate investment also falls. Moreover, many of the capital goods and equipment used in investment activities are imported (Berezinskaya and Vedev 2015). This means that exchange rate depreciation of the sort observed in the second half of 2014 raises the cost of investment, leading to many firms postponing or cancelling planned investment.

There is also some evidence that the composition of investment shifted slightly. According to official statistics, the fastest growth in fixed investment data took place in the sectors associated with military production (aircraft, transport equipment, and other machinery) and food production. The sharpest decline in investment activity took place in extractive industries. This is to be expected given the downturn in energy prices. Because military spending and its associated investment was already scheduled before the imposition of sanctions, and because of the decline in energy prices, it is unlikely that sanctions contributed much to the overall trends described here.

Finally, as illustrated in Figure 9, foreign direct investment in Russia became a net outflow in the second half of 2014. While this is not unprecedented (see 2005, for example), the fact that it accompanied a wider contraction in investment indicates that at the time of writing the prospects for investment in Russia appear bleak. It is likely that this was due to structural deficiencies in the Russian economy, as well as to the decline in oil prices, rather than as a direct result of sanctions. Nevertheless, sanctions added yet another reason for investors – Russian or foreign – to put off investment.

Summary of the economic impact of Western statecraft

As outlined above, the precise impact of sanctions is difficult to discern, and was complicated by the influence of Russia’s own structural economic slowdown and the sharp decline in oil prices that began in the summer of 2014. The direct impact on targeted sectors has been mixed. In terms of output, the defence and energy industries performed relatively well in 2014. This appeared unlikely to change in the short-term. Similarly, the Russian food embargo did not result in a change in fortunes – in either direction -- for domestic producers. The sanctions that targeted the financial sector appeared to cause the most immediate disruption. The sizeable external debt repayments in 2014 made an important contribution to capital outflows, which in turn contributed to the depreciation of the ruble. However, Russia’s overall financial position remained comparatively strong, and it is unlikely that sanctions will be sufficient to induce a financial crisis in Russia, at least in the short-term.

In all instances where sanctions have been imposed, the Russian state has initiated a range of counter-measures, including a wide-ranging import substitution plan, as well as the provision of financial support to targeted firms and sectors. These counter measures may succeed in insulating Russia from the threat of future sanctions due to the weakening of Russia’s economic ties with those countries that imposed the current sanctions. As a result, if these measures are sustained – and the government made it

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28 On recent patterns of FDI in Russia, see Iwasaki and Suganuma 2007; Brock 2005.
clear that they will be – Russia may be much less susceptible to similar external pressure in the future.

**The Impact on Russian Political Economy**

As well as affecting the performance of the Russian economy, Western economic statecraft has also generated a series of policy responses from the Russia government. As well as the imposition of counter sanctions in the agricultural sector, the Russian government has developed, and continued to further refine, a set of economic policies that emphasised self-sufficiency and a reassessment of Russia’s pattern of integration with the global economy. Russia’s response should not be a surprise. Past evidence from the use of economic statecraft – the economic instruments, such as travel bans, asset freezes, trade embargoes, and sanctions employed by Western powers (and their allies) and Russia as instruments of foreign policy -- reveals that those countries that are the ‘target’ of sanctions tend to respond in a relatively predictable manner. This analysis highlights how Russia’s response to sanctions confirms three hypotheses derived from the extant literature on sanctions.

1. *The impact of sanctions varies according to regime type of the target country*

Sanctions affect leaders and populations in different political systems in different ways. As Risa Brooks argues, ‘sanctions that harm the macro economy and thus hurt the “median voter” [are more likely to] be effective against democratic states’, while authoritarian leaders, by contrast, ‘tend to be insulated from aggregate or macro-economic pressures’ and therefore cannot be expected to be as responsive to popular opinion as democracies (Brooks 2002). Indeed, as Susan Allen suggests, the ‘domestic political response to sanctions varies greatly by the regime type of the target. As states become more politically open, the domestic public can—and does, to some degree—create political costs for leaders who resist sanctions’ (Allen 2008). By contrast, in non-democracies, like Russia, leaders may in fact profit from sanctions. Without being accountable to the wider public, elites can do this relatively unchecked, as ‘leaders may actually benefit from sanctions, as domestic publics are unable to

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impose political costs and the economic constraints of sanctions often allow leaders to extract greater rents while overseeing the trade of scarce goods’ (Allen 2008).

Russia’s system of political economy is based on the redistribution of rent flows from its internationally competitive natural resource industries (Connolly 2013; Connolly 2015a; Gaddy and Ickes 2005, Gaddy and Ickes 2010). Revenues generated by oil, gas, and metals exports are used to support high levels of social welfare spending, as well as Russia’s recent rearmament programme. A system such as this, based on the redistribution of rent flows, means that the Russian state was well-equipped to insulate the elite to cushion it from impact of sanctions. As a result, even if economic statecraft imposes costs on the bulk of a country’s citizenry, what is most important from the perspective of the incumbent leadership is whether it can maintain the support of the elite. Over the course of 2014-2015, the Russian leadership was relatively successful in channelling resources to politically well-connected allies. Sanctioned individuals – such as Gennadii Timchenko and Arkadii Rotenberg – received access to lucrative construction contracts, while systemically important firms, such as the state-owned oil giant, Rosneft’, successfully lobbied for access to financial resources from the sovereign wealth fund.

In addition to the state support provided to key members of the elite, it is also instructive that the composition of the federal budget over the course of 2014-2015 also shifted to protect those constituencies that might be considered as integral to the prevailing system of political economy in Russia, including industries like defence, rail machinery, oil and gas machinery and pipelines manufacturing, as well as people dependent on government spending (the so-called byudzhetniki, such as pensioners or those employed in the vast state bureaucracy; see Connolly 2015a). Thus, even though the nominal ruble value of the revised federal budget for 2015 shrank by 5.7%, the budget chapter covering politically-important social policy spending rose by 5.1% (Ministry of Finance, 2015). Although it is true that the chapters reserved for national defence and national security and the legal system declined (by 4.8% and 3.7% respectively), this was a much less severe than the cuts applied to housing and municipal services (-10.8%), environmental protection (-16.1%), the national economy (-8.8%), and health (-8.3%). Therefore, despite challenging macroeconomic
conditions, the Russian government was able to insulate its key constituencies from economic hardship.

2. Sanctions can result in redistribution in target countries that strengthens the existing system

Not only can non-democratic regimes allocate scarce resources to allies of the incumbent regime in order to strengthen elite cohesion, they are also able to redistribute resources to important socio-economic constituencies that will ensure popular, as well as elite, support for the regime. Indeed, as Johan Galtung observes, sanctions can create the conditions for the rise of powerful constituencies in the target nation that benefit from international isolation (Galtung 1967). This is because, in the long run, sanctions often foster the development of domestic industries in the target country, thus reducing the target’s dependence on the outside world and the ability of sender countries to influence the target’s behaviour through economic coercion.

The economic policy climate in Russia since the imposition of sanctions emphasised support for precisely those industries that are targeted by sanctions. Import substitution (*importozameshchenie*) – popular among only a minority before 2014 – became increasingly fashionable among policy-makers, experts and many businesses in Russia. The longer Russia is isolated from the global economy, as will happen the longer sanctions persist, the more likely it is that these forces will grow to dominate economic policy-making. Indeed, the interruption of supply chains prompted a reallocation of resources to domestic industries through import substitution programmes, such as that designed to help build defence-industrial products previously imported from Ukrainian enterprises. In April 2015, Denis Manturov, the Minister for Industry and Trade, presented a plan for import substitution that envisaged the implementation of 2,059 projects across 19 branches of the economy between 2016-2020 (Yedovina and Shapovalov 2015). Of this total, 570 projects were said to be under way by November 2015.

The total cost was estimated to reach over RUB 1.5 trillion, with RUB 235 billion to be supplied by the federal budget. Over the course of 2014-2015, extra resources were allocated to the oil and
gas equipment industry, the pharmaceutical industry, the agricultural machinery and production industries, and, of course, the military-industrial complex. All of these are key economic constituencies that account for a large share of employment in Russia, and all are benefitting from friendly public policies taken as a direct result of the imposition of sanctions.

3. Sanctions can cause a ‘rally round the flag’ effect

Finally, previous episodes of sanctions reveal that sanctions can also generate a ‘rally round the flag’ effect in target countries, in which sanctions lead to an increase in political cohesion within the target state. The imposition of sanctions enables targeted leaders to pinpoint a clear external threat, which can be used as a focal point for a leader to unify the state (Coser 1956; Downs and Rocke 1994; Smith 1996). Leaders can also place the blame for economic hardship on the sender state rather than on their own economic policies, suggesting that sanctioned populations might rally against the enemy or sender state (Mueller 1970; Mueller 1973; Ostrom and Job 1986; Galtung 1967).

In Russia, there is considerable evidence that such a ‘rally round the flag’ effect occurred over the course of 2014-2015. Not only did all opinion polls show public support for the leadership to be near record high levels, with public support especially high for the President, but the Western sanctions regime also gave the leadership a convenient alibi for the structural downturn in the economy described earlier in this article. Without sanctions, it is possible that the leadership would have come under much greater public scrutiny for its poor stewardship of the economy. However, the leadership was able to assign blame for any economic hardship to external enemies. On a broader level, there was also evidence that ‘standing up to the West’ gave many (although not all) Russian citizens a greater sense of pride in their country’s standing on the international stage. Public approval ratings for President Putin, as measured by the respected Levada Centre, rose from 65% in January 2014 to 83% after the annexation of Crimea, and were as high as 89% in June 2015. These were the


The impact of the conflict with the West on Putin’s popularity is discussed in Simes 2015.
highest approval ratings ever enjoyed by Putin. Time may erode this sense of pride felt by many, but in the short-term at least, it was clear that most Russians had indeed ‘rallied round the flag’.

Towards the securitisation of political economy in Russia?

The impact of Western economic statecraft was most observable at the domestic political level. Because statecraft tends to affect non-democracies in a different way to democracies, it was perhaps unsurprising that the Russian leadership was able to reallocate resources to its allies within the elite, and also to key economic constituencies across Russia. Under the mantra of import substitution, economic policy began to take an increasingly introverted and dirigiste turn. Nevertheless, this blend of economic nationalism proved, at least at the time of writing, to be very popular among large swathes of the Russian population.

Taken together, the response to economic statecraft described above can be seen as evidence that Russia’s economic policy debate was becoming increasingly characterised by an emphasis on self-reliance that was justified in the name of security, with economic policy subsumed within a wider effort to insulate Russia from a growing array of internal and external threats. This tendency can be labeled ‘securitisation’ and was affecting an increasingly wide range of areas of economic activity.\(^32\) As of late 2015, official plans for economic securitisation in the form of public statements and government documents and decrees were inchoate and lacking in cohesion. There was no clearly formulated agreement on desired objectives or on the precise means that might be deployed to achieve those objectives. Also, a powerful array of constituencies remains opposed to rolling back many of the market reforms undertaken since the collapse of the Soviet Union. Yet the growing sense of insecurity felt by those in the Kremlin appeared to be leading to an increase in the relative power of those groups in and around the state apparatus that would like to see

\(^{32}\) See Bacon, Renz and Cooper (2006), who adapted Ole Waever’s concept of securitisation to Russia’s domestic politics; securitisation is what happens ‘when normal politics is pushed into the security realm’, and that the ‘securitisation of an issue in a policy sector occurs when a political actor by the use of the rhetoric of existential threat…succeeds in justifying the adoption of measures outside the formal norms and procedures of politics’.
Russia adopt a new agenda for economic development. If, as this article suggests, economic policy was increasingly defined by security concerns – if the process of economic securitisation was already under way – then the ramifications of this policy change may be profound.

Economic securitisation has the potential to change important aspects of Russia’s political economy. These include, but are not limited to: the primary objectives of national economic activity as defined by the state (security v. economic freedom and/or consumer welfare); the means used to meet state objectives (the use and nature of strategic planning); the means of resource allocation (state v. market; large enterprises v. small enterprises); the priority accorded to different types of economic activity (consumption v. investment; agriculture v. other consumer industries); the depth of Russia’s integration with the global economy (the degree to which Russia interacts with the global economy); and the scope of Russia’s external economic ties (with whom and in which areas Russia interacts).

Thus, given the ambiguity surrounding the efficacy of sanctions outlined in the previous section, it is reasonable to question whether Western sanctions exerted the effect that sender countries intended. Instead of causing elite dissatisfaction, elite cohesion appeared to have strengthened. And instead of imposing significant economic pain, sanctions merely gave the leadership a convenient alibi for what was already a poorly performing economy. Their senders surely did not intend these effects, which raises the question of whether more effective instruments could have been used in their place.33

Conclusion

The economic statecraft deployed by Western countries and their allies against Russia in response to its involvement in the conflict in Ukraine since March 2014 has the potential to shape profoundly the nature of Russia’s future economic development. While economic statecraft was employed extensively throughout the Cold War, with only a modest impact on Soviet economic organisation and performance, the recent

33 More effective instruments could have included, for example, a greater emphasis on military responses to Russian assertiveness, or on intensified efforts to target Russian elite assets in the West.
episode has been played out in a radically different context. Over the past two decades, the Russian economy has undergone historically unprecedented liberalisation at home, even if the quality and scope of that liberalisation remains weak relative to Russia’s Western neighbours. Russia has also followed a path of deep, if somewhat distorted, integration with the global economy. As a result, the potential for at least the partial reversal of both domestic liberalisation and external integration is much greater than it was during the Soviet period when the degree of central economic control was much greater.

While the assessment offered here is only preliminary, there are signs that the configuration of Russia’s system of political economy is changing. While the impact of economic statecraft on economic performance was, at the time of writing, difficult to discern, the impact on political economy appeared more pronounced. The economic policy debate in Russia was increasingly characterised by an emphasis on self-reliance in the name of security, with economic policy subsumed within a wider concern to insulate Russia from a growing array of external threats.34 While the nature of the West’s relationship with Ukraine is the most obvious security threat cited by Russian officials, these officials have been clear in stating that there are many other, potentially even more serious, threats to Russian national interests. It is in this context that Russia’s reaction to Western economic statecraft can be more clearly understood: in a world that -- from the vantage point of the Kremlin -- appears increasingly menacing, many officials see economic security as an important component of Russia’s wider security. The centralised management of Russia’s external relations are, for many, a logical response to geopolitical uncertainty.

It is worth noting at this point that the geopolitical conflict with Western powers over Ukraine, in which economic statecraft has been the weapon of choice, did not cause

34 See for example: Security Council of the Russian Federation 2009; and more recently, Ministry of Foreign Affairs 2013. For a discussion of the evolution of the perception of threats to Russian national security see Monaghan 2013.
the shift towards the securitisation of economic policy in Russia. For the past decade, the Kremlin’s revealed preference for hands-on control across large swathes of the economy was clear. However, events subsequent to Russia’s annexation of Crimea accelerated the process of securitisation and weakened those in the technocratic policy elite who traditionally guarded the progress made by Russia, in terms of both economic liberalisation at home, and its current pattern of close integration with the Western part of the global economy.

This should not be taken to mean that Russia is on the verge of resurrecting the centrally planned economy from the Soviet era. The demands of the 21st century economy would make such an endeavour self-defeating. Moreover, the nature of the global economy has changed dramatically since the collapse of the Soviet Union. During the Cold War there were no economically significant ‘third’ powers. This is no longer the case. In addition to the obvious example of China, there are a number of other rapidly growing low- and middle-income countries with which Russia could, in principle, develop closer economic ties. Nevertheless, it is plausible that a new type of system of political economy may be emerging in Russia, and one that satisfies the Kremlin’s urge to deal with what it perceives to be an increasingly threatening external environment.

Bibliography


