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Are the Economic Sanctions against Russia Effective?

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The introduced sanctions against Russia, which at the moment are on a level of travel bans and asset freezes against a limited group of individuals and firms, are unlikely to trigger a profound change in Russian foreign policy. This can primarily be attributed to the fact that the economic impact of the sanctions is rather low. However, the current political tensions have had an impact on financial and non-financial indicators, including a possibly persistent effect on government bond yields.

The political crisis in the Ukraine and Crimea has induced severe tensions between Russia and Western European countries and the United States. The conflict peaked when Russian troops were committed to Crimea after a referendum about the incorporation into the Russian Federation was held at short notice.

Western politicians have reacted with the threat of sanctions, some of which are already in place. Despite the fact that the German, British and US American media does not consider these sanctions to be very effective, this short essay will present some hints that the threat and the execution of sanctions has had some impact on stock markets, Russian government bond yields, and growth prospects.

Timeline of the Ukraine Crisis

Date	Event
21/11/2013	Ukraine suspends preparation for EU trade agreement
01/12/2013	Anti-government protesters occupy Kiev city hall, thousands are calling for President Victor Yanukovich to stand down
08/12/2013	More than 500,000 people take part in a demonstration against President Yanukovich
17/12/2013	Vladimir Putin agrees to buy \$15bn of Ukrainian debt and reduce the price of Russian gas supplies
20/02/2014	88 people die in Kiev during clashes between protesters and government forces.
22/02/2014	President Yanukovich disappears, Parliament sets elections for 25 May, Yulia Tymoshenko is freed from jail
27/02/2014	Pro-Russian gunmen seize key buildings in the Crimean capital, Simferopol. Unidentified gunmen in combat uniforms appear outside Crimea's main airports.
01/03/2014	Russia's parliament approves Vladimir Putin's request to use force in Ukraine to protect Russian interests. Obama tells Putin to pull forces back to bases.
02/03/2014	Ukraine's interim PM Yatsenyuk says Russia has effectively declared war. US says Russia is in control of Crimea.
06/03/2014	Crimea's parliament declares the region wants to join Russia and will let voters decide in a March 16 referendum. Obama announces sanctions, EU leaders hold emergency summit to find ways to pressure Russia
08/03/2014	The US and France warn of "new measures" against Russia if it does not withdraw its forces from Ukraine.
12/03/2014	Obama meets with Yatsenyuk at the White House, declaring the US completely rejects the referendum in Crimea.
16/03/2014	Official results from Crimea's secession referendum say 97% of voters back a proposal to join Russia.
17/03/2014	The EU and US impose travel bans and asset freezes on several officials from Russia and Ukraine over the Crimea referendum.
18/03/2014	Putin signs a bill to absorb the peninsula into the Russian Federation.
20/03/2014	EU leaders meet and extend the list of individuals targeted for sanctions. The US also extends sanctions.
01/04/2014	Nato foreign ministers suspend all practical civilian and military co-operation with Russia at a meeting in Brussels.
07/04/2014	Pro-Russian protesters occupy government buildings in the eastern cities of Donetsk, Luhansk and Kharkiv.
15/04/2014	Ukraine announces start of "anti-terrorist" operations.
16/04/2014	"Anti-terrorist" operation quickly stalls: pro-Russian militants in eastern Ukraine seize six armoured vehicles.
17/04/2014	Russia, Ukraine, the US and the EU say they have agreed at talks in Geneva on steps to "de-escalate" the crisis in eastern Ukraine.
24/04/2014	Obama announces possible new sanctions and stresses the importance of the elections on May 25.
28/04/2014	EU extends list of sanctioned individuals and firms.
11/05/2014	Pro-Russian separatists in Donetsk and Luhansk declare independence after referendums which were not recognised by Kiev
25/05/2014	Petro Poroshenko wins presidential elections, Russia says it is open for dialogue
06/06/2014	Putin holds informal talks with Obama and Poroshenko in Normandie.
14/06/2014	Separatists shoot down military airplane with 49 passengers.

Sources: [BBC online](#), [Reuters](#)

Short Introduction to Economic Sanctions

In the literature, there is no consensus about the exact types of sanctions, but the following broad categories can be found (Cf. Hufbauer et al (2007), [Caruso \(2003\)](#), Kaempfer and Lowenberg (2007):

- Diplomatic sanctions: Withdrawal or expulsion of ambassadors, unwillingness to continue international negotiations.
- Financial sanctions: Suspension of development aid, objections to loans from international organizations (World Bank, IMF), investment bans, asset freezes
- Trade restrictions: Import/ export restrictions (military v. non-military goods), trade embargoes.
- Smart sanctions: Asset freezes or travel bans against certain individuals, companies or groups of people.

In the case of the current political crisis between the West and Russia, the introduced sanctions clearly fall into the last category. Certain politicians, businessmen and journalists from Russia and Crimea are not allowed to travel to the sanctioning countries anymore and their assets abroad are frozen (Cf. Council of the European Commission 2014a, Council of the European Commission 2014b). The latter is also true for some firms, mainly banks and energy companies. The USA has prohibited any commercial relations between US citizens and the sanctioned companies, the most important ones being Bank Rossiya, SMP Bank and the investment firm Volga. More recently, the US [has also banned the export of certain technology goods](#) that can be used for military purposes. In a meeting in March, the heads of states of the EU agreed to a three-stage plan which would only go beyond smart sanctions in the case of a further destabilization of the eastern part of the Ukraine or sabotage against the elections.

Are Sanctions Effective?

The empirical evidence of the effectiveness of sanctions is mixed. While some studies find that smart sanctions, if designed carefully, are quite effective (e.g., Haass 1998, Cortright and Lopez 2000, [Morgan and Schwebach 1995](#)), others suggest that only very harsh measures trigger a significant impact (e.g., [Hufbauer and Oegg 2003](#), [Lam 1990](#)). Moreover, it is common not to measure economic damage, but rather consider a sanction to be successful if it is able to provoke the desired policy change. Hufbauer et al., 2007 find that 34% (40 out of 115) sanctions they examine have been successful. However, Pape (1997) revises this number down to 4% as, for example, many of the sanctions have actually been accompanied by direct or indirect use of force or the target not make the demanded concessions.

Prior to the current crisis, the death of the auditor and businessman Sergei Magnitsky in a Moscow prison in 2009, has led to tensions between Western countries and Russia. These tensions ultimately led to travel bans to the United States and exclusion of Russian officials related to the incident from the US-American banking system (Cf. Public Law 112-208, December 14, 2012). However, it is unlikely that these sanctions have had any significant impact.

But leaving aside the historical success of sanctions, what are the conditions that most likely increase the economic impact of a sanction? Regarding this question, the following characteristics are considered important:

- The size of the economy: Caruso (2003) and Hufbauer et al. (2007) find that the size of the target country is, ceteris paribus, negatively correlated to the impact or success of sanctions. This negative size effect is also in line with economic theory, as described by Kaempfer and Lowenberg (2007), who suggest that large countries are able to absorb sanctions more easily since they are more self-sufficient than smaller countries.
- Economic and political ties previous to the sanctions: Empirical research (e.g., Hufbauer et al, 1990, [Bonetti, 1998](#), and [Jing et al, 2003](#)) finds that sanctions have a larger impact if the sanctioning country is a major trading and/or political partner. This is not surprising, as sanctions or restrictions on trade and finance will obviously have more effect if there is a lot of economic activity in place compared to a situation where there is hardly any connection between countries – this is also the reason why Russia might fear sanctions from the EU more than US sanctions.
- Unilateral or multilateral sanctions: In the case of unilateral sanctions, the target country may be able to sell or buy goods and raw materials from third, non-sanctioning countries (Caruso 2003). Multilateral sanctions, as a coordinated way of several countries to take economic actions, have a higher economic effect, as the possibility to switch trading partners is reduced. The higher impact of multilateral sanctions is also supported by empirical evidence (Caruso 2003, Hufbauer et al. 2007). However, as noted by Kaempfer and Lowenberg (1988), the process of designing sanctions is inherently political, for different interest groups may be affected by sanctions directed against a certain country. Following this logic, multilateral sanctions, as adopted by the European Union, include even more interest groups and therefore may lead to a “weaker” design of the sanctions, as the common denominator is relatively small.

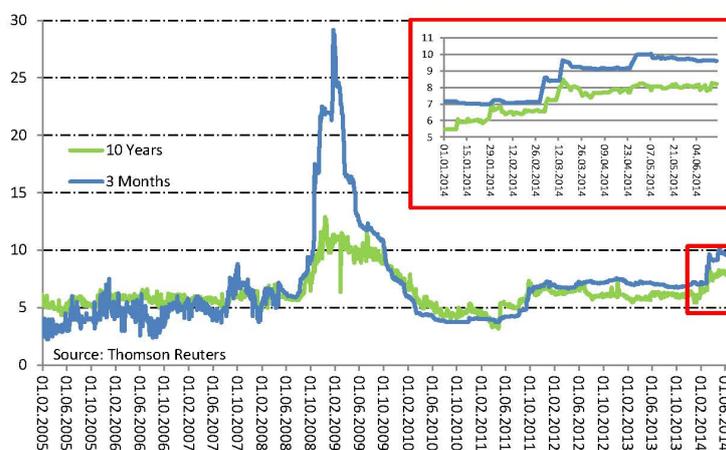
Effects in Russia

Given these conditions, one may be skeptical about the impact of the imposed sanctions on Russia. The introduced sanctions do not include any restrictions on finance or trade (with the exception of some US American sanctions against certain rather small banks) but are rather directed against Putin's confidants. Also, Russia is a large country with exports and imports together accounting for only 40% of GDP (There is a general tendency for large countries to have a lower trade to GDP ratio, as they are more self-sufficient. The US, EU and Japan, for instance, all have an even lower value (imports plus exports amount to only 23-26% of GDP in these countries), while in Belgium, the same ratio reaches 180%). This means that even harsh economic sanctions might not be as effective as they would be in other countries. However, the EU is the most important trading partner of Russia, which, of course, means that the threat of sanctions of the EU is certainly more worrying for Russia than sanctions announced by the US: in 2013, the trade turnover between the EU and Russia reached 326 billion euros, while the trade turnover between the USA and Russia was only about 21 billion euros ([Deutsch-Russische Auslandshandelskammer \(2014\)](#)).

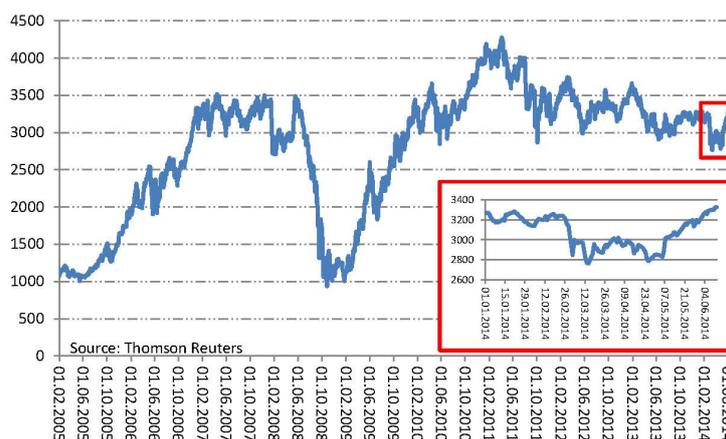
Nevertheless, Russia has already shown reactions to sanctions and political tensions in the West, orienting itself eastwards: recently, Gazprom signed a long-term contract with China about gas deliveries worth 400 billion US dollars and infrastructure programs.

But even though the introduced sanctions are rather weak compared to other examples in recent history (cf. Hufbauer et al., 2007), the political crisis and the threat of economic sanctions has had an impact on some indicators of the Russian economy. Thanks to the availability of some daily data, the process of the political crisis, including the announcements of sanctions, can be observed in government bond yields and stock markets (MICEX, Moscow). Also, the crisis seems to have influenced the exchange rate, but due to monetary activism and inflationary pressures, the link between the political crisis or economic sanctions and the exchange rate is less clear in this case. Below, the most important economic figures that were affected by the political crisis are depicted.

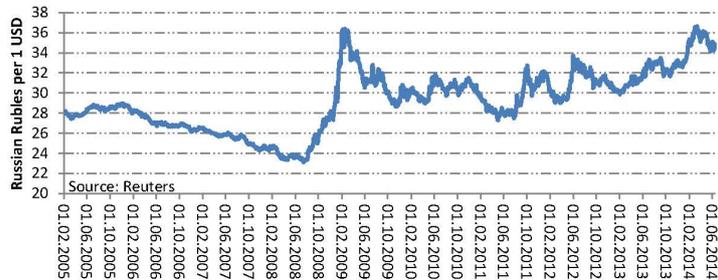
(a) Russian Government Bond Yields, February 2005 to June 2014



(b) MICEX 10 Index, February 2005 to June 2014



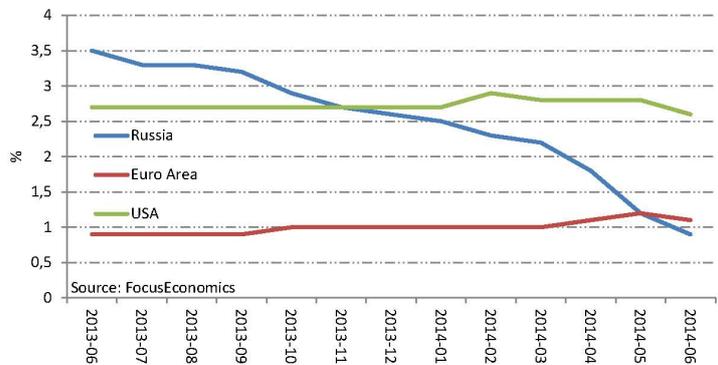
(c) Russian rubles per 1 USD, February 2005 to June 2014



(d) Net Capital Outflows, Russia, Q1 2005 to Q1 2014



(e) Growth Predictions for 2014



Government Bonds

Government bond yields for short- and long-term securities reveal two different aspects of the crisis, as is shown in graph (a). First, the yields for short-term bonds soar from 7 to around 10 % in response to two main events: the first spike can be observed after the weekend of the 1st and 2nd of March, during which Russian troops invaded Crimea. When the markets opened on Monday, 3rd of March,

investors' worries about possible political and economic consequences as well as country risk manifested themselves in the short-term yields. A similar pattern can be observed on March 12. Several things occurred during the days before, including the announcement of sanctions against Russia by President Obama and the heads of states of the European Union.

Second, long-term yields rose from 6 % in February to around 8 % in June and have stabilized at this higher level. Even more than the (volatile) short-term yields, the long-term yields reflect the increased country risk that investors have priced into the overall yield.

Moreover, on April 25, 2014 Standard & Poor's downgraded Russian government bonds to BBB-, just one level above junk, as a consequence of the ongoing tensions. It warned that further downgrades were possible if the West imposed tighter sanctions against Moscow.

All in all, compared to the bond yields dynamics over the last 10 years, the recent spikes are rather small. Moreover, the long-term bond yields went somewhat down after the first surge indicating that investors do not expect the effects of the events to be substantial.

Stock market

The MICEX 10 Index is a price index of the ten most liquid corporations listed on the Russian stock exchange MICEX-RTS. The political tensions and possible sanctions only had a temporary effect on the stock market: As can be observed in graph (b), the presence of Russian troops in Crimea let the index fall by nearly 300 points, more than 9%, when the floor opened on Monday, March 3 (Military interventions, in particular if unexpected, generally trigger negative effects on stock markets in the involved countries, cf. [Schneider and Troeger\(2006\)](#). However, the authors note that in some cases, war can also lead to a positive reaction from stock markets.) After a short recovery, the index fell again and reached its lowest closing value since 2009. Since the beginning of May, however, investors seem to have regained confidence in the Russian market and pushed the MICEX index back to levels above the values before the Crimea crisis. This recovery is particularly remarkable in the light of the Central Bank of Russia's measures of monetary contraction to support the weakening ruble.

However, if the stock market is examined in a long-term perspective, the effect of the Ukraine crisis and of the possible sanctions is only marginal.

This again demonstrates that the Ukraine crisis triggered swift reactions, which have been rather transitory and had no profound impact on the Russian stock market.

A particularly interesting observation is that while the stock market has now returned to pre-crisis levels, government bonds still deliver a very high return, indicating a divergence between public and private assets when it comes to the assessment of country risk. The current stock market rally might also be induced by the recent gas crisis, since Gazprom, Lukoil, and Rosneft are included in the MICEX 10. The need for Russian gas (and oil) was reflected in the latest negotiations and might have pushed up the prices for stocks of energy companies in Russia.

Exchange rate

The ruble has depreciated sharply since the beginning of 2014, which is when political tensions started to unsettle Ukraine, as is also visible in graph (c). It reached its lowest value for ten years when Crimea was occupied by Russian troops. In response to the this rapid decline in value of the Russian currency, the Central Bank of Russia raised interest rates and intervened on international foreign currency markets to strengthen the domestic currency, buying up rubles worth a 20 billion USD. This policy might be an explanation why the ruble has stabilized after peaking in March, even though the general trend since 2010 is pointing upwards, primarily due to high inflation. However, the effect of the Crimea crisis and the connected fear of economic sanctions or consequences are quite substantial and might have been even larger, in the absence of the policy actions by the Central Bank of Russia.

Capital outflows

In accordance with the observations of the exchange rate, the negative effect of the political crisis is also reflected in net capital outflows (graph (d)): In the first quarter of 2014, the net capital outflows amounted to more than 50 billion US dollars, the largest value since the deepest point of the financial crisis in the late 2008. This noticeable increase in capital outflows from Russia indicates that uncertainty among investors has increased, which may also be linked with the threat of sanctions by Western countries.

During the last years, capital outflows have been the rule rather than the exception in Russia, as they reflect the trade surplus due to Russian energy exports. However, if the recent increase in outflows is rather rooted in the lack of investor confidence than in a current account surplus, this may cause troubles to the already weakening economy (Deutsche Bank 2014).

But can the effect of sanctions against Russia and the ongoing political crisis also be shown in non-financial data? Trade and FDI data are not as readily available as financial figures, but one way of measuring the economic impact of the sanctions against Russia is to look at how the predictions of Russian GDP growth have changed over time.

Expected growth rates

Graph (e) shows FocusEconomics consensus forecasts made by private sector experts about the expected growth rates in the Euro area, Russia, and the United States. While the forecasts for the former two remain relatively stable, there is a very clear downward trend in the outlook for the Russian economy. It is not fully attributable to the political crisis or Western sanctions, as there are also other underlying factors which either hamper growth or are part of forecast bias (Forecasters tend to be too optimistic about future growth prospects (cf. [Ager et al., 2009](#)). Therefore, the more a future point in time approaches the present, the more forecasters realize their unrealistic optimism and adjust their predictions downwards. Remarkably, this seems not be the case for the USA and the Euro area for 2014 growth rates.) Furthermore, as stated by [Deutsche Bank \(2014\)](#) and [DIW Berlin et al. \(2014\)](#), the Russian economy was already losing pace by the time when the implementation of sanctions was announced.

Nevertheless, the most significant changes from one period to the next occur between March and May 2014, which coincides with the peak of the political crisis in Crimea and the announcements of sanctions by the EU and USA. This indicates that these events have had an impact on the growth prospects of the country, even though the real impact on GDP will have to be assessed at a later point in time.

In a [recent country report](#), the IMF states that the Russian growth model relied too heavily on high oil and gas prices, while productivity has not increased and structural reforms are necessary. Also, the IMF acknowledges the importance of the sanctions and the crisis with Ukraine, which poses “a significant downside risk” and lowers its economic outlook for Russia to a mere 0.2% growth rate for 2014.

Conclusion

Given the historical comparison to other countries that have been sanctioned in order to alter their political behavior, the prospects that the currently implemented sanctions will trigger the desired outcome, in this case the normalization of relations to the new Ukrainian government and respecting the territorial integrity of this country, are rather modest. In addition, a possible change in Russia's attitude towards its neighbor countries may not be solely attributed to the implemented sanctions.

Even though it is too early for a serious quantitative assessment on how much economic damage the sanctions of the EU and the United States have caused in Russia, it can be stated that most of the effects, if any, have occurred due to the expectation of more sanctions or the symbolic character, which may have discouraged investment into Russia and increased the perceived country-specific risk. Further, it should be stressed that it is extremely difficult to disentangle the different elements of political tensions that have evolved in the Ukraine crisis and what their respective effect has been; the presence of Russian troops in Crimea has obviously created negative effects on Russian government bond yields and the stock market, but it is not clear whether the prospects of a possible armed conflict or expected economic sanctions were the driver for this development.

It remains unclear what the effect of broad economic sanctions instead of targeted individual sanctions might be; some commentators (Cf. Michael Thumann in: Die Zeit, June 12, 2014: „Unberechenbares Russland“; Mark Schieritz: „[Stufe Drei tut richtig weh](#)“, May 15, 2014,) believe that Putin's recent deescalating behavior is connected to fear of this third stage of sanctions. However, the political leaders of the EU and United States have not been very concrete with regard to these measures so far.

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