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POLICY BRIEF

Economic Sanctions as a Foreign Policy Instrument: The Case of Russia

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Starving a nation of resources has a long history in foreign policy, from ancient sieges of cities to modern economic sanctions. Sanctions can come in many forms: a unilateral trade embargo like the 1980 US grain embargo against the Soviet Union during the Carter administration; a multilateral sanction like the ongoing (since 2013) United Nations arms embargo on the Central African Republic; or targeted trade and financial sanctions by a coordinated group of countries that cut off the flow of goods, services, and capital to entities and individuals—such as the ones now being imposed by the United States, Europe, and others against Russia.

The Russian economy is already projected to contract by 6 percent this year.[1] If the group of 40-plus allied countries were to impose a total trade embargo, the estimated trade and economic losses would be even higher.[2] Worse, from Russia's perspective, foreign direct investment (FDI) is expected to continue to drop substantially. Russia needs FDI for productivity growth and sustained economic growth. Economic growth and development are complex, and it takes more than a simple plug to fill a "capital gap," as classic development models postulate.[3]

THE RUSSIAN ECONOMY

Russia's trade patterns are largely consistent with a developing country—rich in natural resources but lacking capital, Russia exports primary commodities and imports capital-intensive goods. Technological progress, innovation, and knowledge are essential to economic growth, which underscores the importance of FDI in Russia. For instance, a US law firm setting up an office in Moscow, a Japanese auto manufacturer building a production plant in St. Petersburg, or a Western technology conglomerate providing software solutions for Russian firms—these are all examples of FDI, and they all lead to increased innovative activity with spillovers to Russian firms and upskilling of Russian workers.[4]

After the Soviet Union fell in 1991, Russia began its transition away from a centrally planned economy and, by around 2000–2005, President Vladimir Putin was on a mission to integrate Russia into the European and world economy. As Putin sounded a welcoming tone to foreign investors, capital poured in and FDI inflows grew from approximately $3.5 billion in 2002 to almost $75 billion in 2008, and about $69 billion in 2013.

But since the invasion of Ukraine, over 1,000 multinational companies (and counting) have curtailed operations in Russia.[5] The suspension of business operations or outright withdrawal reflects various factors, such as higher legal costs, higher costs of doing business to avoid banking and trade sanctions, uncertainty caused by armed conflict, or need to protect brand reputation. The decreased presence of multinationals will inevitably manifest as a negative shock to sector-specific total factor productivity.

ARE SANCTIONS EFFECTIVE?

Sanctions are more likely to create costs for the target country if the imposing countries' efforts are multilateral and coordinated, the imposing countries share the same goals, and the sanctions target the specific individuals, businesses, financial institutions, and entities that are facilitating the unsavory act. Whether such costs will coerce the target country to change course is another matter, though. As economists Kimberly Elliott, Gary Hufbauer, and Barbara Oegg note, "Senders usually have multiple goals and targets in mind when they impose sanctions, and simple punishment is rarely at the top of the list."[6]

But sometimes punishment is the only thing that is feasible. Elliott, Hufbauer, and Oegg analyze 116 sanctions from World War I to the UN embargo of Iraq (1990–2003) and identify five conditions under which sanctions were most likely to alter the behavior of the target country:

- When the goal is relatively modest.
- When the target country is smaller than the imposing countries.
- When the target and the imposing countries were friendly with each other and economically integrated before the sanctions.
- When the sanctions are imposed quickly and decisively (so the target country has little time to plan workarounds).
- When the imposing countries can avoid high costs.

Looking at these conditions, it is difficult to predict the effectiveness of the current sanctions. For instance, the goal—for Putin to withdraw from Ukraine—is not necessarily modest, although

Russia's economy is smaller than the US and European economies. Russia's outsized role in oil and gas also makes the situation harder to gauge. Russia's relationship with the United States has not been friendly, and the two countries have not been economically integrated, but Europe relies on Russian energy and has stronger economic ties with Russia. The sanctions were slow to come about, and Putin has figured out many workarounds. For example, Russia continues to receive billions of dollars in oil and gas revenue, and oligarchs around the world are managing key financial flows for Putin's regime. In terms of the ability of the imposing countries to avoid high costs, the US economy is better positioned than that of Europe.

The allied sanctions on Putin and his regime have brought on economic and financial costs, yet so far they have been insufficient to instigate withdrawal from Ukraine. What would have happened without any sanctions at all? Unfortunately, it is impossible to know. Perhaps a future up-close look and play-by-play recount of the inner workings of the Putin regime and Putin's own considerations before, during, and after the invasion and the sanctions will enable historians to weigh the actual effectiveness of the allied sanctions and their impact on his decision-making process.

There is an excellent ex post empirical analysis of the 2014 sanctions against Russia for its annexation of Crimea. Daniel Ahn and Rodney Ludema use detailed firm- and individual-level data to examine the effects of targeted sanctions imposed by the United States, European Union, and others on specific Russian individuals, firms, and entities. They find significant losses in operating revenue, asset values, and employees for sanctioned firms compared with their nonsanctioned peers. The sanctions were effective in imposing costs on key entities, yet they did not persuade Putin to give back Crimea or dissuade him from further invasions.[7]

WHAT IF THE WEST IMPOSED A COMPLETE TRADE EMBARGO ON RUSSIA?

In a recent study, Kornel Mahlstein et al. estimate the potential economic effects of a complete trade embargo on Russia and Belarus by the United States, United Kingdom, European Union, and other allied countries, including Japan, Australia, South Korea, and Iceland.[8] The sanctions run the gamut of export and import restrictions, travel restrictions, limits on dealings with Russian banks, investment bans, and suspension of international cooperation.

In order to simulate the complete trade embargo, Mahlstein et al. specify import and export taxes that are so high that they are effectively prohibitive, rather than using flat-out bans. They specify import tariffs of 260 percent on Russian goods by allied countries for each sector and export taxes of 95 percent across the board. Putting this in context, the average US import tariff is 2.4 percent.[9] Bermuda had the highest average import tariff rate in the world in 2020, at almost 25 percent,[10] less than one-tenth of the rate proposed. Similarly, Russia had the highest export tax in the world, at about 19 percent, followed by Argentina, at 16.5 percent, in 2019.[11]

Imposing these sanctions would be expected to result in Russia's imports being cut by about one-half and exports by over one-fifth and the Russian economy shrinking by almost 15 percent. Russia would be expected to experience this loss despite the fact that China, an important trading partner of Russia, would not be participating in the embargo. In this scenario, most of the allies would experience minor reductions in both imports and exports, generally under 1 percent of annual value, while a few countries would experience small increases in imports. Some non-allied countries would see increases in imports and exports as trade is diverted.

In terms of the economic impacts, most allied countries would experience higher trade costs and an inefficient reallocation of resources. Mahlstein et al. find that the toll is unevenly distributed in interesting ways:

- Highly integrated allied countries, the countries more integrated with Russia (Germany, Netherlands, and Central/Eastern Europe), would suffer the most, unsurprisingly.
- Resource-rich allied countries (Canada, Norway, Australia, United States) would experience a terms-of-trade improvement as their export prices increase relative to import prices.
- Resource-poor Far Eastern allied countries (Japan, South Korea, Taiwan) would suffer owing to rising import prices, specifically their dependence on imported fossil fuels.
- Western European allied countries (United Kingdom, France, Italy, Switzerland) would also be adversely affected by higher fossil fuel prices because they are net importers, but only moderately.

CURTAILING FDI MATTERS MOST FOR RUSSIA'S LONG-TERM GROWTH

Notably, Mahlstein et al. find that the largest contribution to Russia's economic pain is the loss of FDI from subsidiaries of businesses headquartered in the allied nations. Russia's estimated GDP losses would be 14.8 percent in the case of the suspension or withdrawal of about half of FDI and upwards of a staggering 28 percent in the case of complete FDI withdrawal.

Sanctions dampen the prospect of doing business in Russia, and private investors are already fleeing the country as the conflict with Ukraine continues. Amazon suspended access to Prime, Apple stopped selling its products, Samsung followed suit, Honda suspended exports, and General Motors stopped all operations. Mastercard and Visa are leaving, whereas other investors, particularly mining firms with vast sunk costs, are finding it difficult to exit.[12] Trade sanctions make it challenging for firms to access intermediate inputs and components from abroad that are used in domestic manufacturing and production. Financial sanctions also hinder their access to capital and ability to process payment transactions.

Today, being excluded from financial markets and electronic networks can be crippling. Some Russian banks have been excluded from the Society for Worldwide Interbank Financial Telecommunication (SWIFT) clearing system (the messaging system global banks use to communicate), which significantly increases the costs of financing, insuring, and executing trade deals even with parties in countries that are not imposing sanctions. The costs of sanctions are not limited to the allies and Russia; they spill over to other businesses and consumers in other nations.

Armed conflict is the environment least conducive to investment. Furthermore, the Russian government is making it harder to withdraw capital and repatriate profits as it tightens capital controls. These capital controls and the deterioration of the rule of law tend to encourage capital flight, which is the exact opposite of what the capital controls are designed to do.

THE RUSSIAN ECONOMY FACES A ROUGH ROAD AHEAD

Over time, trade and financial sanctions hold back the flow of both knowledge and capital to Russian businesses and workers, and the exit of foreign firms and diminished access to critical imports of technology and inputs leave a rough road ahead for the Russian economy. Rebuilding trust and attracting capital once it has fled is no easy task. The effects will play out for many years to come.

China, India, and Brazil are all examples of emerging economies that, at times through the 20th century, withdrew behind tariffs and high trade barriers as they sought to grow alone, arguing for self-sufficiency. But instead, they all found stagnation.[13] Growth and development need more than just filling the “capital gap” or the “technology gap.” The development process is far more organic. Links to innovative firms, both upstream and downstream, and the dynamics of competition with and among those firms are necessary. Simply put, there is no substitute for the exposure to innovation and competition that the global economy offers.

THE LEGALITY OF SANCTIONS

The sanctions as discussed are termed “autonomous sanctions” and imposed by individual nations without the authorization of the United Nations. To simplify a complex matter of international law, sanctions “undertaken in response to a . . . breach of peace or act of aggression” [fall] within the jurisdiction of the UN Security Council.[14] Once the Security Council has decided under Article 39 of the UN Charter that there is an “act of aggression,” sanctions are determined under Article 41.[15]

Because Russia holds a veto on the Security Council, it is unlikely to be subject to sanctions under UN authorization. Furthermore, cases of the Security Council taking action are rare, other than in the 1990s, when sanctions were imposed on Iraq, Somalia, Libya, Haiti, Sudan, Lebanon, Rwanda, and a handful of other countries.[16]

But Russia, already subject to autonomous sanctions following its actions in Crimea in 2018,[17] is experiencing increasing severity of sanctions, including participation from nations not directly affected by its invasion of Ukraine. Nations that are directly affected can impose sanctions for national security reasons because all treaties that might conflict with the sanctions have exemptions for national security, including the UN Charter, Article XX1(b) of the General Agreement on Tariff and Trade, and Article 99 of the Europe Union–Russia Cooperation and Partnership Agreement (CPA). All nations have a right to self-defense under UN Charter Article 51.[18]

Russia's questioning of the legality of the sanctions failed when the International Court of Justice rejected its claims under the CPA.[19] However, the legality of the sanctions imposed by other nations not directly affected—like the United States, Australia, Japan, and Canada—is less clear.

On the one hand is the norm of noninterference in the affairs of other states. On the other hand, the peremptory norm of obligation *erga omnes* ("towards all")—that is, the obligation a nation owes to the international community—and a breach of that obligation is a matter of concern to all nations.[20] Russia's actions in Ukraine might be considered to meet the requirements of *erga omnes* obligation. The Articles of State Responsibility, Article 48, and the commentaries prepared by the International Law Commission are consistent with an interpretation that such sanctions satisfy international law obligations.[21]

CONCLUSION

The legality of these sanctions has been challenged by Russia, but they are arguably justified under existing international law. Mahlstein et al. also find that a complete trade embargo by the West and withdrawal of FDI have the potential to reduce Russia's GDP by 28 percent. The United States and allied economies would suffer, but the effects would be unevenly distributed, with Europe experiencing greater adverse effects, reflecting its greater economic ties with Russia and reliance on Russian energy.

Although Russia's oil revenues are increasing at present, its ties to the global economy are disintegrating, and its economy is entering a long descent into isolation. The decreased presence of multinationals will inevitably manifest as a negative shock to sector-specific total factor productivity.

The longer sanctions stay in place, the greater will be the pressure by the US exporters and importers to "cheat" or to carve out exemptions. Alternatively, there might be pressure to impose protectionist measures under the guise of sanctions. US lawmakers should resist such tangential measures, because such measures would undermine the sanctions and be harmful to American consumers and businesses.

The Russian economy is paying for the political decisions of its leaders. For the allied countries, the importance the public places on foreign policy goals will determine whether the economic and noneconomic effects of the sanctions are worth the cost.

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NOTES

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