THE IMPACT OF POLITICALY MOTIVATED TRADE SANCTIONS ON RUSSIA'S FOREIGN TRADE SECTOR

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The specific situation at the current stage of development in the sphere of Russia's foreign trade (including exports) has been shaped by the influences of the following three key factors: low activity on world markets due to the continuing uncertainty in the global economy; stagnation in Russia's national economy and its major sectors; and the introduction of political sanctions and restrictions in the sphere of trade and economic exchange.

Taken together, these circumstances have given rise to a spectrum of negative synergic effects that have affected, among other things, the volume of Russia's national exports, their sectoral structure and geographical distribution, as well as the results of government support rendered to exports of products other than raw materials.

In this connection, Russia's foreign trade sector is going to function under entirely new conditions, and so the newly emerging external challenges and internal limitation will have to be seriously taken into consideration during the implementation of the RF government's plans in the field of export policy[1], with a view towards their inevitable adjustment at some later date.

The government promises support to domestic exporters when they enter global markets, including protection of their interests through the mechanisms available in the framework of the World Trade Organization (WTO). However, the developments observed in recent months in Russia's foreign trade sector have been quite controversial. Thus, it has been suggested that certain measures should be taken in order to implement the policy of de-offshorization, which may have very dramatic consequences for domestic exports. The business community fears that the adoption of the proposed draft law (designed to toughen the rules for offshore companies) in its current wording may disrupt export supplies, including exports of technologies.

It should be emphasized that one of the main reasons for Russian companies to operate in offshore zones has been their desire to lower the possible risks for creditors who participate in the funding and implementation of large-scale export contracts. However, problems may arise not only with regard to newly introduced legislation, but also as a result of implementation of certain law enforcement practices in the future.

Another natural growth-restricting factor to be taken into consideration is the shrinking export potential of the Russian Federation, coupled with the degradation of its structure. Thus, for example, according to data released by Russia's Federal Customs Service (FTS), exports of goods from Russia in 2013 increased by only 0.3%, while exports to the CIS member countries shrank by more than 7%. The share of energy carrier supplies amounted to 74.5% of Russia's aggregate exports, and by the end of the first half year of 2014 it had already increased to 75.5%. The share of the so-called 'machine and technologies' exports in total exports amounts to only 5.4%, while the products supplied by the defense-industrial complex (DIC) account for more than 50% of that amount.

As a result, over the first eight months of 2014, the growth rate of Russia's exports dwindled to almost zero (resulting in a hardly noticeable 0.6% growth on the same period of last year), while exports to the EU – Russia's principal sales market – shrank by 1.5%, and exports to some of Russia's traditional partners in trade – by 35–40%. Exports to the CIS dropped by 4.5%, and specifically exports to Ukraine – by 1.5%[2].

The conflict with Ukraine is bound to dramatically bring down the scale of Russia's export to that country (which in 2012 rated fifth in importance among Russia's markets for exports) – including not only natural gas supplies, but also the supplies of a broad range of other commodity items. This trend is being sustained by the increasing risks associated with any such deals, as well as the possibility of restrictions that Ukraine may impose in the future.

Such a trend can hardly be compensated for by increased exports to other countries across the post-Soviet space (regarded as sales markets comparable in scale to Ukraine), in view of the newly emerged and palpably growing uncertainty in the political and eco-

1 Government Program 'Foreign Trade Development'; the Agency for Strategic Initiative's (ASI) Roadmap 'Support for Access to Foreign Markets and Export', etc.

2 *Vneshniaia torgovlia Rossiiskoi Federatsii po osnovnym stranam i gruppam stran v ianvare – avguste 2014* [Foreign Trade of the Russian Federation, by Major Country and Country Group, in January–August 2014]. Federal Customs Service (FTS), 8 October 2014.

nomic situation within the framework of the CIS. Given the current broader geopolitical environment, it is also unlikely and highly improbable that exports to the developed countries may be increased.

Besides, stagnation in the national economy, and especially in the industrial sector, results in shrinkage of export-oriented industries, and first of all those unrelated to the production of raw materials. Latest expert's estimations, and even official forecasts, directly point to the possibility of further decline in the value of exports – among other things, because of the rapidly falling oil prices.

Moreover, the successful implementation of government programs for exports support will depend crucially on allocation of substantial budget resources, needed primarily in order to boost financial support measures designed to promote Russia's non-raw material exports (through *Vneshekonombank* and its affiliations). However, in the current situation of budget constraints such a prospect appears to be unlikely even in the medium term.

There is little hope that instruments applicable within the framework of the WTO can actually be used in order to protect and promote the interests of Russia's domestic businesses (at least in the medium term), because – as demonstrated by our unhappy experiences of recent years – one must first learn how to apply these instruments on a professional level. Moreover, it seems that the RF Government no longer believes in exports being the driving force of development; the main source of hope at present is the possibility of budget funding, as well as investment and credits – including foreign borrowings; these are viewed as growth boosters, but in view of the toughening sanctions such sources are becoming unavailable.

Success of the implementation of plans aimed at gaining access on world markets and supporting exports has become far less certain since the spring of 2014, when nearly all the developed countries launched a campaign of step-by-step international sanctions against Russia. This campaign has been joined by approximately 40 countries led by members in the Organization for Economic Co-operation and Development (OECD). Besides, some countries (primarily the states belonging to the 'Anglo-Saxon bloc') have introduced some additional sanctions on a national level. On the whole, these countries and international groupings (the EU, the European Free Trade Association (EFTA), the USA, Canada, Australia, etc.) account for approximately two thirds of Russia's commodity turnover and exports as well as for a large share of services and technologies imported by Russia. Moreover, they also represent Russia's major source of foreign direct investment (FDI).

It should be emphasized that so far we could find few in-depth reviews of the theoretic aspects of economic sanctions in literature on the theory of economics[1]. Therefore, many Russian and foreign experts base their analysis of the international sanctions against Russia and their possible consequences on the similarities between the current situation and the developments in Iran and other countries over the past 8–10 years, which we believe to be a fundamentally erroneous approach.

In view of the depth and scale of the current geopolitical conflict, it must be compared with the policy of Western countries towards the USSR in the 1980s in response to the Soviet military intervention in Afghanistan in December 1979. As early as January 1980, the USA and her allies launched all-embracing blanket sanctions against the Soviet Union, including the boycott of the 1980 Olympic Games in Moscow. Coordinated measures in the sphere of trade and finance were introduced at once and involved an embargo on the supplies of technologies and other items of critical importance for the USSR (including imports of high-strength large-diameter pipes for natural gas pipelines, and even such trivial products as cereals), restrictions on the key items of Soviet exports, a ban on lending and offering credit to the Soviet Union, and so on. These measures delivered a heavy blow to the poorly balanced administrative-command economy of the USSR, which was based on central planning.

Besides, without embarking on a discussion of conspiracy theories, one can simply point to the fact that, over the period 1985–1986, Saudi Arabia tripled its oil output. This pushed down prices on the world oil market from \$ 30 to \$ 12 per barrel, which exerted a strong negative impact on the national economy of the USSR, with its very heavy reliance on exports of oil and foreign credits[2]. During the period of perestroika the afore-said sanctions were gradually lifted, but these positive developments came too late to significantly improve the situation in the USSR economy chronically plagued with serious systemic problems.

It is noteworthy that the Soviet Union got observer status in the General Agreement on Tariffs and Trade (GATT) only as late as 1990 (after a decade of fruitless negotiations on the issue), thus drawing a line under the long saga of the 'Afghanistan sanctions'. Judging

1 See, e.g., *Economic Sanctions Reconsidered*, 3rd Edition by Gary Hufbauer, Jeffrey Schott, Kimberly Elliott and Barbara Oegg. Peterson Institute for International Economics, Wash., 2009, 248 p.; Pape R. *Why Economic Sanctions Still Do Not Work*, International Security, Vol. 23, Issue 1, Harvard, Summer 1998, pp. 66–77.

2 For further detail on this issue, see Gaidar Ye. T. *Collapse of an Empire*: *Lessons for Modern Russia*. 2nd ed., revised. – M.: *Rossiiskaia politicheskaia entsyklopedia* [Russian Political Encyclopedia] (ROSSPEN), 2006. – 448 p.

from the past, it can be confidently assumed that today' Russia has found herself in a position of *de facto* international isolation, which will probably last for years. The USA and the EU treat the Crimea's accession to the Russian Federation as Russia's blatant annexation of an integral part of the territory of Ukraine. It should be said that this stance is definitely fraught with grave consequences for Russia[1].

Even if some of the restrictions are eventually lifted, little will be changed in the long run. In this connection it should be borne in mind that both in the EU countries and the USA the legal framework governing international relations is constructed in such a way that sanctions can be introduced promptly, without much delay, if consideration is given to the political resonance of a given event. However, these measures will not be easy to abolish due to the influence of various involved parties who have vested interests in the matter.

For example, this was the case with the notorious Jackson-Vanik Amendment (1974), which was at long last abolished by the USA in 2012 for the sole reason of Russia's accession to the WTO (to comply with the so-called requirement of most favored nation status in trade), only to be replaced by another discriminatory bill – the Magnitsky Act.

It must be understood that international economic relations are complex dynamic systems, which normally operate in conditions of equilibrium. In case of any disruption of this equilibrium, due to the global character and mutual dependence of all the political and economic processes involved in it, it can only be restored over a lengthy period of time, with a lot of effort. So, the combination of both direct and implicit sanctions can be expected to produce the following negative effects on Russia's exports sector in the short- and medium-term perspective:

- the introduction of sanctions on the international and national levels (importantly, they do not contradict the established norms of the WTO) against the Russian Federation, its legal entities and physical persons will generally downgrade the image of Russian exporters and make more difficult their operation in complicate on the external markets of some countries and regions;
- the suspension of the major forms of official contacts between the developed countries and Russia on the intergovernmental level in the sphere of trade and economic cooperation pulls down the quality of governance, monitoring and planning across the entire network of foreign trade relations between domestic and foreign partners in the public and private sectors conducted in bi- and multi-lateral formats[2];
- the selective withdrawal from cooperation with Russia in the framework of NATO, NASA, etc. does not affect the foreign partners' key interests, but restricts their Russian counterparts in their access to the most attractive fields (funding for joint programs, supplies of technologies, access to information, exchange of human resources, etc.);
- the downgrading of the sovereign (credit) rating of the Russian Federation[3] will make it more difficult or more expensive for some Russian companies and banks to attract new foreign loans and to apply for debt restructuring (re-crediting)[4], including the requests for loans to fund the development of exports; the primary targets here are state-owned companies – the leaders in the exports of raw materials and industrial products. In effect, the most destructive blow to the Russian economy has been the ban on offering medium- and long-term credits to Russian state banks and state-owned companies, which also includes the sphere of export contracts;
- the freezing of joint projects with the participation of foreign capital (those that are currently being implemented and those that are planned for the future) will reduce the inflow into this country not only of FDI, but also of related state-of-the-art technologies and best managerial practices, with the inevitable negative impact on the prospects for developing the most promising sectors of the economy, including exports.

1 For example, the USA never recognized the accession of the Baltic republics to the USSR in 1940. The US standpoint on that issue remained unchanged for half a century, until the Baltic countries regained their independence in 1991.

2 As early as March 2014, many government agencies of the developed countries refused to hold meetings of the corresponding Intergovernmental Commissions on science & technology and economy & trade cooperation with Russia, as well as to participate in other official events in the framework of their Intergovernmental interaction with the Russian Federation.

3 After the sanctions have been declared, the top three international rating agencies (Moody's, Fitch, S&P) promptly revised their sovereign rating for Russia and the credit ratings for the companies and banks subject for restrictions, downgrading them from 'stable' to 'negative', thus automatically pushing down the ratings for all Russian legal entities of the same class.

4 As of early 2014, foreign debt of Russia's corporate sector amounted to $ 653bn, that of the public sector – to $ 79bn. Over the period from March through December 2014, Russian companies will have to redeem their debt in the amount of $ 67bn, and banks – their debt in the amount of $ 36bn. Biznes-Zhurnal [The Business Journal], 3 April 2014. The RF Central Bank believes that Russian banks and companies will have to pay a total of $ 134bn by the end of 2015 (in December 2014 alone, the colossal sum of $ 32bn will have to be redeemed). Finansovaia gazeta [The Financial Newspaper], 23 October 2014.

In this connection it should be remembered that the law-abiding businesses in the developed countries, in spite of their explicit protests, will generally follow in the wake of the political course taken by their national governments instead of demonstrating independence in the commercial sphere. The hopes of Russian companies that their Western partners would be able to find ways to bypass the sanctions are proving to be unrealistic, because the latter do not want to take risks. Foreign suppliers and economic operators in this case are faced with some real dangers, and therefore their reaction is quite understandable. Thus, last summer, BNP Paribas had to pay nearly $ 9bn in its settlement over violation of sanctions imposed against Sudan, Iran and Cuba. In late summer, a similar punishment was levied against Germany's *Commerzbank* – the amount of fine may amount to no less than $ 650m. In such a situation, it will be simpler and cheaper for foreign companies and banks to weigh anchor and leave the Russian market for good;

- the refusal of the leading developed countries and groups of countries to further discuss with their Russian partners the prospects of cooperation agreements in key areas of trade and investment policies seriously undermines the possibilities for developing any new forms of interaction, including in the sphere of Russia exports of goods, services, technologies, and FDI.

Thus, in particular, in early March 2014 the EU refused to carry on the negotiations with Russia concerning the New Basic Agreement on the Simplification of Visa Formalities; the USA discontinued negotiations on the draft trade and investment agreement; Japan cancelled the conclusion of a new investment agreement, and so on;

- the discontinuation of cooperation in the field of military technologies between the developed countries and Russia coupled with targeted sanctions against certain Russian military enterprises will suppress the scale and diversification of Russia's exports of armaments and dual-use technologies in the medium term[1].

In addition, in July 2014 the EU and some other developed countries agreed upon an embargo (i.e., a complete ban) on imports and exports of military equipment and related technologies to and from Russia, which is directly detrimental to Russia's national defense-industrial complex and armaments exports as a major source of its development ($15bn in 2013).

Firstly, Russian companies are losing their sales markets to the value of several billions USD per annum – which include not only the developed countries, but also their allies, as armaments trade is very highly politicized. Secondly, although imports of military equipment, spare parts and technologies from the developed countries into Russia is estimated to amount only to a few hundred million USD, these imports are crucial for state-of-the-art arms production oriented both to the domestic and foreign markets;

- the international sanctions per se and the suspension of the negotiations to establish free trade zones (FTZ) between the member states of the European Free Trade Association (EFTA) and New Zealand, on the one hand, and the Customs Union, on the other, will definitely exert indirect negative effects on various aspects of the integration processes going on within the framework of the Common Economic Space (CES). Some other geopolitical consequences arising as a result of the conflict in Ukraine will have adverse effects in Russia's relations with the other CIS members[2];
- the suspension of Russia's membership in G-8, the discontinuation of the negotiations on Russia's accession to the OECD, and Russia's dwindling activity in international organizations will not only be detrimental to this country's reputation, but will also exclude it from taking part in discussions and the decision-making process with regard to the most important global problems, thus noticeably undermining its position in the world economy.

Taken together, all these consequences will be detrimental to all the parties involved, but it certainly seems that Russia will be by far the biggest loser. This will happen due to the fact that the degrees of dependence on trade of Russia and the countries that have initiated the sanctions are spread asymmetrically. So, it is necessary to take an objective view of the situation and evaluate it without fear and without excessive optimism, always remembering that the trade and economic potentials of the parties are indeed incomparable (Russia's potential being 15–20 times lower than that of her opponents).

On the whole, the aggregate loss resulting from the sanctions is estimated by experts to be at the level of 1–1.5% of Russia's GDP. This sum is derived on the basis of the capital outflow volume, the drop in the capitalization of Russian Blue Chips on the MICEX and the London Exchange, the rise in the price of credits,

1 According to data released by the European Commission (EC), Russia's exports of weapons to the European Union amount on the average to € 3.2bn евро, and European exports – to approximately € 300m. Kommersant, 20 July 2014.

2 In this context, the signing of agreements with the EU on in-depth and comprehensive association not only by Ukraine, but also by Moldova and Georgia appears to be quite logical.

and other losses, including the loss of profits. At the same time, the aforesaid factors have emerged in conjunction with the overall worsening on the situation in Russia's national economy and finance, thus giving rise to a negative synergic effect.

It should be noted that a threat of sanctions per se adds an element of uncertainty to the economic situation, which sometimes works even more effectively than the actual restrictions or embargo. In this connection, one should react reasonably to the threats and refrain from aggravating the situation still further by invented 'asymmetrical' retaliatory measures. Russia's economy strongly depends on exports and imports, and so serious restrictions imposed from inside on imports and exports of goods and services may promote stagnation and deepen the other problems faced by the national economy.

In view of these facts, the declarations of many Russian politicians and experts that the sanctions are not associated with any serious risks and threats sound like empty bravado. The most vivid example of such an approach is the introduction of retaliatory sanctions in the form of a complete ban on food imports into Russia from the developed countries. As stated by the RF government, 'all this is our response to the sanctions imposed by the West, who by doing so made more harm to themselves than to Russia'[1]. However, one must be fair and admit a certain evolution in the government's approaches to economic matters, which are becoming more realistic.

One can indeed adapt to sanctions, and even learn how to bypass them, because new opportunities for doing business are emerging even in conditions of imposed sanctions. In this case, one interesting example is the mobilization potential of South Africa's national economy during the period of international embargo. Besides, some preventive measure can be implemented in order to minimize losses.

The Russian government is attempting to elaborate measures designed to alleviate the effect of sanctions and reduce losses, but these attempts rely on the concept of isolationism – enforced settlements in rubles, the creation of a national payment system, the pursuance of a tough de-offshorization policy, a cutoff of economic ties with the developed countries, and the implementation of the RF government's new foreign trade strategy which envisages Russia's turn to the East.

In effect, the leaders of this country are putting forth a policy of import substitution as a national idea, with reliance on certain sectors of the national economy, which can be explained in part by the ruble's depreciation, the current shortage of loanable funds, and the effects of international sanctions. The domestic economic policy is based on the old recipes applied during the recent crisis, such as recapitalization of state banks and financial institutes, and the granting of preferential loans and government guarantees to 'system-forming' companies. This approach also appears to be aimed at large-scale import substitution by mobilizing biggest economic players.

Even if the current geopolitical crisis (the conflict with Ukraine) should be resolved in the foreseeable future, the effects of sanctions will be such as to require many years of coordinated professional efforts of the Russian government in order to bring back to normal the situation in the foreign trade sector, and first of all to ensure smooth development of this country's export potential. The main goal in this case will be to minimize losses, identify external risks and find the necessary internal reserves, make the economy more open, and – most importantly – take advantage of new opportunities for implementing reform.

1 *Nezavisimaia gazeta* [The Independent Newspaper], 19 August 2014.