Russia's Response to Sanctions May Not Put Economic Considerations First, Say Analysts

July 25 (BNA) -- Economic sanctions against Russia are expected to push the world's eighth-largest economy into recession by the end of this year, and economists say possible self-inflicted wounds in the form of retaliatory measures may exacerbate the damage.

European Union member states reached a tentative agreement July 25 to impose a broad range of new sanctions over the crisis in the Ukraine (see related story in this issue). The most recent U.S. sanctions, were announced July 16.

The U.S. has barred its financial markets from issuing new debt with maturity terms of more than 90 days to two of the largest Russian banks—VEB and Gazprombank—and energy companies Rosneft OAO and Novatek OAO. The immediate effect has been seen in flights of capital as investors pull out of Russia in anticipation of further economic isolation.

For an economy that was already slowing down, the economic hit all but guarantees a recession in Russia.

“You cannot take a hit like $75 billion worth of capital flight versus $63 billion last year, and we're only halfway through the year,” said Christopher Hartwell, president of the Center of for Social and Economic Research (CASE) in Warsaw, in an interview with Bloomberg BNA. “The Russian economy was already slowing down, private consumption had collapsed, and investment was already nonexistent.”

Hartwell said he anticipates that Russia's gross domestic product growth will contract by about 0.8 percentage points this year, and added that he “wouldn't be surprised, if depending on future sanctions, if it gets down to a contraction of 1 percent. Russia is going into a recession, there's no doubt about it.”

Russia's Tolerance for Pain

Russia could retaliate by withholding energy exports, a move that would hurt the EU much more than the U.S., because Russia provides the bloc with 30 percent of the EU's natural gas consumption. Analysts also raise the possibility of Russia defaulting on external debt to hurt foreign creditors. But either action would have a nearly equally deleterious effect on the Russian economy, said Stanislav Secrieru, a senior research fellow focusing on Russia at the Polish Institute of International Affairs in Warsaw.

“The sanctions are not only about producing a direct impact on the Russian economy,” Secrieru said in an interview with Bloomberg BNA. “We have to look also at how Russia reacts to these sanctions and by its own actions in the economic field reinforces the impact of those sanctions.”

The most recent example of Russia's willingness to strike back came in April, when Russian President Vladimir Putin signed a new law enabling the creation of a national payment system and mandating tough new rules of operation to the foreign payment systems Visa and MasterCard (87 DER EE-1, 5/6/14). Morgan Stanley estimated the total cost for Visa and Mastercard might have reached nearly $2.9 billion. The proposal was in response to the first round of U.S. sanctions against Russia following the Ukraine crisis, which caused Mastercard and Visa to deny service to the two largest Russian banks in an effort to comply.

As of July 15, the Russian government had softened its stance, and said the companies could continue to do business, but would be required to use a Russian payment system to process their transactions.

Secrieru said a decision by Russia to bar imports would also take a toll on that nation's own companies.

“These kinds of actions would have a debilitating effect on the Russian economy because it deprives them of high-tech or high performance equipment and would reduce the efficiency of Russian companies who need those imports,” Secrieru said. In the past, Russia has “tried to retaliate, but they are just shooting themselves in the foot, twice. The more they try to close the economy, the worse the situation will be for them,” he said.

EU's Energy Dependence

The EU has more to lose than the U.S. from any countermeasures from Russia. The European Parliament discussed a plan this week to reduce its dependence on foreign energy, a situation that leaves it particularly vulnerable to Russia (142 DER A-5, 7/24/14).

The EU imports 53 percent of its total energy needs and 90 percent of its crude oil, 66 percent of its natural gas, and 42 percent of solid fuels like coal.

“Europe is also heavily dependent on one single supplier, namely Russia, responsible for a third of oil imports, 39 percent of gas and 26 percent of solid fuels,” according to a fact sheet released by the EU July 24.

But those figures are not evenly distributed throughout the union, and as the fact sheet noted, Russia is the only source of gas imports for six EU countries. This dependence on Russian energy “makes it quite clear that energy is Russia's ‘trump card' relative to the EU and the countries of Eastern Europe,” Wells Fargo economists said in a July 24 research note.

“Russia could potentially curtail its energy exports to other countries for a short period of time for geopolitical reasons, much like OPEC embargoed oil exports to western economies at the time of the 1973 Arab-Israeli conflict,” the economists said.

The U.S., conversely, only uses Russian supplies for 5 percent of its crude oil imports, which accounts for just 3 percent of total U.S. oil consumption, according to Wells Fargo. Within the EU, Russia's leverage diminishes with distance. Russia supplies 37 percent of Germany's crude oil imports, and roughly 12 percent of imports for the France, Italy, Spain and the U.K.

A Russian embargo of its energy exports would probably cause Europe's economic output, and possibly the global economy, to “nosedive,” according to Wells Fargo. But the energy story in the EU isn't just about Europe's dependence on Russia, it leaves the Russian economy vulnerable as well. Mineral fuels make up two-thirds of Russia's total exports, and energy exports contribute nearly 20 percent of the country's GDP.

For Putin, Power Is Priceless

The economic ramifications of such actions can be quantified, but predicting just how far Russia is willing to go in response is not as easy. Russian authorities would have to carefully weigh a decision to embargo energy exports, and the geopolitical gains could outweigh the economic considerations.

Russia has benefitted from some very good economic policy makers over the past 14 years, especially under Putin's first and second terms, said Hartwell. Hartwell joined CASE two months ago, after more than two years in Moscow as the Head of Global Markets and Institutional Research at the Institute for Emerging Market Studies at the Moscow School of Management. The Russian central bank has also been very good at understanding the economic cycle, and with the ministry of finance has implemented sound policy and moved toward international best practices, Hartwell said.

“The problems come in when Putin does get involved in economic policy, and following from his political views decides that [Russia] needs to project power, and thinks, ‘We need these grand projects, we need to have the Sochi Olympics, we need to have the APEC [Asia-Pacific Economic Cooperation] summit, we need to have the World Cup,' and these are just gigantic swamps of corruption where money is just disappearing,” Hartwell said.

Rather than economic policies targeted at building a middle class, rural development or a healthy small business sector, Putin targets policy at large projects that are only adding to public debt, Hartwell said. “Putin only understands his political power, and economic power is secondary to it,” Hartwell said. “And that's really the problem that is coming about in Russian finances.

“The break-even price for the Russian budget is now $125 a barrel of oil, where it used to be $90, and before that it was $60, he said. “They're spending so much and not getting any return. A select few are getting a return, but on the other hand, hey, everyone's feeling good about themselves.”

‘We Told You So.'

Russia's pursuit of political ideology over economic strength threatens to destabilize both sides, but in Europe, that tactic could be the only way forward. A U.S. Treasury official challenged the notion that businesses wouldn't support the economic sanctions against Russia during a July 16 background call with reporters announcing the latest sanctions.

“They, like businesses everywhere, want the burden to be shared, but in terms of understanding that there are burdens to be borne for broader principles beyond just the bottom line, I don't think our businesses have any difficult with that notion,” the official said.

The European countries with the strongest trade and energy ties to Russia are counterintuitively the ones supporting a harder stance by Europe, Hartwell said.

“You've got the Baltic states, Lithuania, which has really been taking the lead on this, Poland and Estonia all pushing for harsher sanctions because they can feel the bear breathing down their neck,” Hartwell said.

Leaders from eastern and central Europe gathered with U.S. policy makers including former National Security Adviser Stephen Hadley and Sens. John McCain (R-Ariz.) and Chris Murphy (D-Conn.) at the Atlantic Council's Global Forum in Wroclaw, Poland, held in early June, to discuss Ukraine and Russia. Polish Foreign Minister Radek Sikorski said Putin had done the West a favor by forcing the issue and magnifying what is “at the bottom an ideological struggle again, unfortunately.”

Hartwell, who attended the forum, said it was clear how the experience of Soviet occupation filters the way these countries must view the Russian question. “Sikorski got up there and said ‘I don't want to tell you that we told you so, but we told you so,' and then [President] Toomas Ilves from Estonia got up and said ‘I didn't want to tell you that we told you so, but we told you so,' ” Hartwell said.

The Crimean conflict was removed enough for EU leaders to avoid taking a stand with harsher sanctions, but the crash of Malaysia Air Flight 17 in Ukraine, believed to have been shot down by Russian-supported rebels, has changed the environment, Secrieru said. More than 200 of the flight's 283 passengers were EU citizens, shredding whatever remove Europe may have felt from the conflict.

“The EU is not a single actor, it has 28 faces, unlike the U.S., which makes it more difficult to make such decisions, and there have also been the concerns about how it would affect the economic recovery in Europe,” Secrieru said. “But you know, now you look at the crisis after the airplane was shot down, and one has to ask what he [one] puts first—the value of human life or economic interests? The European Union, as a project, was based upon respect for human life and had this as its highest value.

“So the EU must now face its basic, fundamental value, which is human life and dignity,” he said. “If you trade your values, you undermine the entire structure.”

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For More Information

For the Treasury Department release on the latest U.S. sanctions go to http://content.govdelivery.com/accounts/USTREAS/bulletins/c49f75?reqfrom=share.

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