EconoFact Chats: Gauging the Effectiveness of the Sanctions Against Russia

Christopher Miller, The Fletcher School, Tufts University

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Michael Klein:

I'm Michael Klein, executive editor of EconoFact; a non-partisan web based publication of the Fletcher School, at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies. Publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

When Russia invaded Ukraine in February 24th, 2022, there was a swift reaction from the United States, Japan and European nations, with the imposition of trade sanctions, financial sanctions, and sanctions against Russian oligarchs. Early on, these seemed to have punishing effects on the Russian economy. The forecast for Russian economic growth went from 2.5% before the invasion, to minus 10% in it's immediate wake. And the ruble fell in value by more than 30%. But since then, growth forecasts have recovered. And the ruble is stronger than it was before the invasion. In a recent article in Foreign Affairs, Professor Christopher Miller, my colleague at Tufts' Fletcher School wrote that the initial impact of sanctions has been less than the West hoped for, or the Russian[s] feared.

Michael Klein:

But he also discusses in that article, the longer run corrosion that sanctions will have on the Russian economy. Chris is a historian of international politics and economics, with a focus on Russia. He is a prolific scholar, and the author of many articles and three books, including the 2018 publication, Putinomics: Power and Money In a Resurgent Russia. Chris, thanks for joining me once again on EconoFact Chats.

Christopher Miller:

Thanks for having me, Michael.

Michael Klein:

Chris when we last spoke, that was in March of 2022. You mentioned that the Russian economy is the 11th largest in the world. The Russian economy is not expected to shrink by 10% this year, as was initially thought after the invasion of Ukraine. But it's prospects still don't look particularly good.

Christopher Miller:

That's right, Michael. Russia's economy is still going to shrink fairly substantially this year. Probably around 5%, depending on where energy prices go over the coming months. Inflation has spiked to double digit rates. Although it's coming down to some extent, over the last couple of months. And sanctions and export controls are having an effect; less dramatic than initially thought, but still, there's a pretty dramatic effect on the Russian economy ,and it's felt unevenly across Russia, with different impacts on different parts of Russian society. And different sectors of the economy. And of course, from the perspective of the war, the worst effects are not in economic terms. But rather, on the several tens of thousands of Russians who have been killed in the fighting. In addition to many Ukrainians of course, as well.

Michael Klein:

Let's pick up on the way the sanctions are affecting different segments of Russian society. The most high profile set of sanctions are on oligarchs, members of the Russian legislature, the Duma, and others in President Putin's circle. What are these sanctions?

Christopher Miller:

So the U.S alongside allies in Europe and the UK, have imposed fairly strict sanctions that prohibit many members of the Russian elite -- both members of the government, officials and also business elites, from traveling to the West. But also, from interacting with Western financial systems. Owning assets, for example. Or conducting bank transfers.

Christopher Miller:

And this has really cut out a large number of Russian elites, from interacting with the global economy. Because once you are subjected to tough U.S financial sanctions, it becomes very difficult to deal with almost any economic actor, or any bank across the world.

Michael Klein:

How leaky do you think these sanctions might be, Chris?

Christopher Miller:

Well, there's no doubt that there are leaks. For example, if an oligarch is sanctioned, they can often transfer their assets to their spouse or to their children, and still exercise de facto control, even if they're not legally in charge. There's also ways you can set up shell companies in jurisdictions that don't provide the financial transparency needed to track ultimate ownership.

Christopher Miller:

But at the end of the day, I think it's pretty clear that the individual sanctions do have a really substantial effect on people who are placed on sanctions lists. Which is why there's such an extensive effort underway by people who are under sanctions to lobby, and get themselves taken off sanctions lists.

Michael Klein:

So if these sanctions are having an effect, I imagine one of the goals of the sanctions is for the oligarchs to put political pressure on President Putin. Is that a reasonable expectation?

Christopher Miller:

Well, it's probably not that likely. If you think of oligarchs, they're people who accumulated economic power in Russia. But they've been able to hold onto their businesses or their financial assets only insofar as the security services who actually run the country have let them. And I think the oligarchs know that if they begin expressing too many political beliefs, or especially any sort of disagreement with the government's policy, their status as an oligarch comes into question. Because it's not difficult at all, for the government to take their assets. To jail them, to exile them. Or even in some cases, to kill them.

Christopher Miller:

So it's unlikely that pressure is going to be placed on the government from the economic elite. I think much more likely if there is pressure placed on the Kremlin or on Putin personally, it comes from the security services rather than from oligarchs.

Michael Klein:

So the sanctions on the assets of individuals is combined with other financial sanctions, such as the exclusion from the SWIFT system. We have an EconoFact memo on there, that was published early on after the invasion. But can you explain what the SWIFT sanctions are? And what other financial sanctions are, please?

Christopher Miller:

Yeah. That's right. The SWIFT sanctions as well as sanctions on individual banks, have been quite impactful on Russia. SWIFT is a messaging system that lets banks communicate with each other, as they undertake transactions. And a number of big Russian banks, but not all, have been cut out of SWIFT. Which is based in the European Union, and therefore, subject to EU rules.

Christopher Miller:

And in addition to that, potentially even more impactfully, the U.S and the EU have blacklisted a number of big Russian banks, making it illegal to undertake certain types of transactions with them. And many of the biggest Russian banks, with the exception of Gazprombank, which is the bank that transfers much of the payments for Russian gas and oil, have been subjected to these tough sanctions.

Christopher Miller:

And this has created huge problems for anyone doing business with Russia. Or anyone in Russia, trying to do business with the outside world. Because many of the banks they used to make payments via, are now unable to transact with suppliers or customers in the West. And so when we've seen disruptions to Russian supply chains or Russian trading relationships, it's often been because it's now very difficult for Russian firms to transact with the outside world. Unless they're going through a very small number of banks, or dealing with a specific set of products whose transactions are still allowed by Western rules.

Michael Klein:

One of the most striking actions in terms of the sanctions, was the freezing of the assets of the Russian Central Bank, that were held outside of Russia. This led to a collapse of the ruble at the outset of the war, as I mentioned in the introduction. But subsequently, it recovered.

Christopher Miller:

That's right. And there were a number of steps that Russia took to support the ruble. And one key step the West took, that actually had the somewhat unexpected effect of supporting the ruble...on the side of the Russian government, the Central Bank imposed sweeping capital controls that limited the ability of Russians to move money outside the country, or to undertake conversions between rubles and dollars. And it also hiked interest rates pretty dramatically, slowing economic activity, but also encouraging Russians to hold their savings in rubles.

Christopher Miller:

And this had the effect of supporting the ruble in the early months of the war. But probably even more importantly than the capital controls, were the fact that Russian imports collapsed. Russia generally runs a current account surplus, but it spiked higher in the months since the war began, because although Russia is still exporting pretty substantial sums above all in oil, which is Russia's largest export in dollar terms, Russia's imports have collapsed partially because of the financial disruptions that we previously discussed. Partially because many of the goods that Russia used to import are now illegal to sell to Russia, under Western export controls. Partially because many Western firms simply pulled out of the Russian market, and stopped selling directly to Russia. And so, Russia's spending only half as much money on imports as it did before the war. As a result, Russia's current account has shot higher into surplus. And that's taken a lot of pressure off the ruble. So we've actually seen the ruble appreciate to a level above where it was when the war began, precisely because of this fairly unique dynamic with Russia's balance of payments.

Christopher Miller:

And in fact right now, the ruble is higher than the Russian government would like. The Russian government's been trying to find ways to push down the value of the ruble, because they're actually dissatisfied with the current level.

Michael Klein:

So the current account that you're mentioning, another name for that is a trade balance. So they're running a big trade surplus, which is not a good thing in this case. Trade surpluses can be good or bad. In this case, it's not a good thing.

Michael Klein:

You've discussed already, this issue of the sale of Russian oil and natural gas. How important are these hydrocarbon exports to Russia? And have sanctions affected the country's ability to export oil and natural gas?

Christopher Miller:

The sanctions were designed to target Russia's long term oil and gas production, but not to impact the short term. And this was part of how both Europe and the U.S set out to sanction Russia. The rationale was that Russia was a crucial provider of oil and gas to European, but also to global markets. And that insofar as Russian supply could be kept online in the short term, it would give Europe time to adjust to a longer term without such reliance on Russian energy. And there was a logic to this strategy. But it meant that Russia would continue to receive substantial revenue from its sales of oil and gas, during the initial phases of sanctions. And that's indeed, what we've seen over the past couple of months. Russia's begun to sell its oil at some discount, to global benchmark prices -- around $20 or $30 a barrel cheaper than most other countries sell oil. But nevertheless because of where the price of oil is today, Russia's making more or less the same amount of money it made as last year, in terms of selling oil. In the long run, Western sanctions will have an impact on Russian oil production. Because, it's become illegal to invest in certain types of complicated oil drilling projects, for example, which is designed to reduce Russia's long run production.

Christopher Miller:

When it comes to gas, the West imposed a similar strategy. Sanctioning the long run, but leaving the short run much less impacted. But Russia has responded with it's own measures that function like sanctions. Restricting the supply of natural gas to Europe, such that right now, Russia's supplying only a tiny fraction of what it normally does to Europe, in advance of the winter season, which is when Europe needs more gas for heating. Now this is a Russian sanction rather than an EU sanction, that's restricting the supply of gas. But the result has been to drive up gas prices and energy prices more broadly across Europe, as Europe struggles to find the energy it needs for its winter.

Michael Klein:

So the idea of that of course, is that by Russia doing that, they want to make it very painful for Europe to have these sanctions, and hope to break down the solidarity.

Michael Klein:

But moving on to other kinds of trade sanctions. In your Foreign Affairs article, you say these other sanctions on trade are probably more important, especially in the long term. For example, parts from America, Europe, or Canada are vital for the maintenance of Russian planes. And we're seeing planes grounded. And the grounded planes, cannibalized for parts. There are ways to get around this, I imagine, but only for a while, and not forever. What do you think the ultimate effect of these sanctions will be?

Christopher Miller:

I think it's already clear that the manufacturing sector in Russia, is going to be among the worst hit by Western sanctions. We've seen this in aviation, as you mentioned, where there's really a small number of producers of advanced aviation equipment. And that largely in Western countries, that are imposing export controls on Russia.

Christopher Miller:

In automobiles, we've seen really dramatic declines in Russian car production. At the peak of the fall earlier this summer, Russia was producing less than 10% of the normal number of cars it would produce. And to adjust to a world with fewer Western components, and to less access to Western expertise in the auto sector, Russia's legislature has been passing rules for example, allowing cars without air bags or antilock brakes. Types of technologies that Russia relies on imports to provide.

Christopher Miller:

And so across manufacturing, we're already seeing and will continue to see disruptions to supply chains, to component parts. And also in the medium and longer term, disruptions to the types of advanced tooling that you need to outfit factories. Most of the machine tools that Russia uses in it's factories for example, are imported from Europe or Japan. And these are sophisticated machinery that can't be imported from anywhere else. The only providers are in advanced economies. And so in the long run, I think this is going to be quite devastating for the Russian manufacturing sector because, there simply aren't replacements that they can acquire from countries that aren't participating in the sanctions.

Michael Klein:

Going back to what I raised earlier about the distributional effects of this, this is going to affect people who work in industries. And as you also point out in your Foreign Affairs article, and I'm going to butcher the pronunciation of this, but Monogorod...how do you pronounce that?

Christopher Miller:

That's pretty good.

Michael Klein:

Oh, okay. Well, thanks. I had a Russian grandmother. So these Monogorods are places where there's basically, a one industry town. And these are going to be devastated by this.

Michael Klein:

Can you talk a little bit about the distributional consequences of manufacturing being hurt very badly in Russia by the sanctions?

Christopher Miller:

Yeah. It's a key issue. And there's a geographic aspect to this, and then there's a labor force structure aspect. In terms of the geography, the way the Soviet Union distributed factories across the Soviet Union, across Soviet Russia left a large number of factories and industrial facilities in towns in Siberia and the Urals region and the far East, where there was only one industry in town. And so when those industries face economic pressure, when they face pressure to lay off employees, it's not just an economic issue. It's a social crisis for the towns in questions, since there's often no other source of employment. And many of the firms in question, are going to be facing, or are already facing some substantial pressure from the economic downturn. And Russian research institutes that have looked into the issue have found that depending on how you classify them, at least half of these cities will face a really substantial effect from the sanctions in place. And so, these geographies are potential sites where there could be not only economic issues, but also, social and political pressure that results from them. But more broadly than that, across Russian society, what we've seen is that the government's strategy to respond to the shock of sanctions and economic downturn is going to be push the cost when necessary, onto the populace, by letting living standards decline, in inflation adjusted terms. And I think eventually, in letting wages decline as well. And manufacturing will be a place where I think, we'll see that more pronounced than other sectors of the Russian economy. Simply because manufacturing is more exposed to the downturn, than other sectors.

Michael Klein:

So you mentioned the political consequences. How severe will those be? You already said that you think the pressure from the oligarchs won't be that effective on changing Putin. Is the same true for the pressure on the population at large?

Christopher Miller:

Well, I think this is an open question. The lesson of the past decade is that the Russian populace is willing to tolerate declining living standards. If you adjust for inflation, disposable incomes are below where they were one decade ago, which is a pretty bad economic track record. But the government's had no real issue managing that, thus far. It's had to tighten [inaudible] to a certain extent, but there haven't been any large political counter reactions.

Christopher Miller:

Now I think the question is, we've already had a decade of declining real incomes. The decline we're going to see this year and next year, will be on top of this decade of decline. And the magnitude will be a lot larger. And so I think there is more concern than previously, in Russian elite circles, about managing the working class in Russia. Managing the middle classes in a context of a stagnating, or declining economy.

Christopher Miller:

But whether this is likely to lead to large scale protest movements, I'm still somewhat skeptical. We haven't seen any evidence that's emerging. There's been no large scale protests in Russia at the national level, in over a decade. And I think we're in waiting mode to see what in fact, does materialize. But the evidence thus far I think, suggests that insofar as there is dissatisfaction with the economy, it would be manifested at the elite level rather than the popular level. Right now we've seen very little evidence at either level, of dissatisfaction leading into some sort of political pressure on the government to change course.

Michael Klein:

In fact, a lot of people have been voting with their feet. A lot of the Intelligentsia and the elites, have been leaving when they can. What's the effect of this brain drain on Russia, in the short run or in the long run?

Christopher Miller:

That's right. It's a big issue. There's not really great data on the numbers of Russians who have left. And of those who have left, we don't know yet what percentage will return. Or what percentage have left permanently. But by any metric, I think the numbers are substantial. And all of the evidence that we do have, suggests that those who have left are disproportionately well educated, have higher incomes, are from the larger cities. And therefore, their departure will mean a larger economic loss for Russia. So the long term cost I think, is quite substantial. It's hard to put a number on, given the uncertainties involved. But it's real. And I think one of the saddest parts of the Russian government's strategy on this issue is that the Russian government I think, realizes that the great error the Soviet Union made was to keep the populace bottled up in the Soviet Union, and didn't let them leave, for a long time. And the current government in Russia thinks the best strategy is to let anyone who wants to leave, leave. Take the economic cost that comes with it. But they're left at home with a population that's more quiescent. Because the Intelligentsia and the types of people who would be most likely to mobilize politically, now live in Berlin or London or San Francisco.

Michael Klein:

Chris, what about the countries that aren't participating in the sanctions? China, I guess India, to a certain extent. What role are they having? Are they helping to rescue the Russian economy? And how big a rescue can they actually provide to it?

Christopher Miller:

I don't think I'd look at it like rescuing. If you look at trade flows between China, between Turkey, between India, what you'll find is that these country's exports to Russia have declined dramatically, when you adjust for seasonal factors in the case of Turkey. The decline for example, in Chinese exports to Russia is roughly the same as the decline of European exports, in percentage terms. So in fact, I think regardless of [inaudible] companies are responding to the risk of sanctions, and also, responding to the economic downturn in Russia in comparable ways. I think where you've seen countries step in and establish new relationships with Russia that have been helpful to Russia, is in terms of buying Russian energy products. And in particular, as Europe has begun to prepare to reduce it's purchases of Russian oil and oil products, India in particular, has stepped up as a buyer of Russian oil. And that's been valuable to Russia, because it gives Russia a customer for it's oil. The Indians I think, have negotiated a pretty tough bargain with Russia. Which is why Russia's selling a lot of it's oil at a discount. And according to recent news reports, Russia's actually beginning to offer long range, long-term oil contracts, at 30% discount to market prices, which suggest that Russia's current customers are negotiating pretty good deals with Russia, at substantial costs to the Russian government and Russian oil firms, because, they're taking advantage of the sanctions environment. Taking advantage of the fact that Russia has a really bad negotiating position right now. And driving a hard bargain, when it comes to buying Russian oil. So I don't think this is an Indian rescue, for example, of Russia's economy. Certainly, it's not done with Russia's interest in mind. But rather, the interest of Indian oil consumers.

Michael Klein:

Well Chris, this is obviously an evolving issue. I appreciated that you spoke with me in March about this, at the outset. And that you're taking the time to speak with me again today, about something that is really important for not just the world economy, but the world political system as well. So thanks again for joining me today, Chris.

Christopher Miller:

Thanks for having me.

Michael Klein:

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