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Sanctions against Russia: The New Normal

- **Sanctions, in particular financial sanctions, have forced Russian businesses to pay off their foreign debt before maturity and decreased the appetite of foreign investors, intensifying capital outflow**

- **This created a short-lived panic on the FX market at end-2014, but in the beginning of 2015 other factors became more important in determining the ruble rate**

- **Both import inflation (due to the depreciated ruble) and food inflation (due to Russian counter-sanctions on food products) have added to inflationary pressures**

- **Sanctions had no significant impact on trade with the EU or the US**

- **Due to the decisive government intervention and inflation-targeted policy of the Russian Central Bank, the effect of the sanctions waned of quickly and are currently negligible**

- **In the long-term, we expect that the sanction regime will impact Russia's productivity by depriving the country of knowledge that is essential for its key sectors**

- **Sanctions relief is unlikely to materialise prior to March 2018 due to domestic political conditions (pending Russian and German elections; the investigation into Russian hacking in the US)**

- **Beyond that date, a new roadmap for Minsk II implementation is the most likely path forward. In this roadmap, concrete steps should be linked to 'carrots' from the EU and US**

Sanctions against Russia began due to the Ukraine crisis

In March 2014, the European Union (EU) and United States (US) enacted sanctions against Russia in response to its illegal occupation of Crimea and support for secessionist groups in eastern Ukraine. At first, these were individual sanctions against specific people and companies. Then in July 2014, additional sectoral sanctions were imposed that limited foreign financing for public banks and oil and gas companies, and restricted Russian oil and gas companies' access to advanced production technologies. In response, Russia imposed an embargo on a wide range of agricultural products from Western countries in August 2014.

There are diverging perspectives on the extent to which Western sanctions have impacted the Russian economy. In November 2014, the Russian Finance Minister estimated the annual cost of sanctions to be 2% of GDP. Similarly, Russian President Vladimir Putin has stated several times that the sanctions are 'severely harming Russia'. However, other reports (IMF, World Bank) argue that the sanctions have only had a marginal impact. In this report we will look at the economic effects of the sanction regime against Russia and analyse how the relation between Russia and the West could develop in the future.

Main conclusions:

(1) Sanctions did not bring Russia to its knees and the effect abated over time

Although sanctions initially contributed to a sharp fall of the ruble, the effect had already waned in 2015. The sanctions seem to be having a longer-lasting impact on foreign funding for businesses and headline inflation. But even so, effective policy by the Russian Central Bank (CBR) prevented FX shortages in the Russian private sector. In addition, inflation fell sharply in 2016 and almost reached the central target of the CBR in May this year (4.1%). In 2016 and early 2017, Russia's economy largely stabilised on the back of higher oil prices. Russia's economy showed positive growth in Q4 2016 and Q1 2017. Still, in the long term we expect that the sanction regime will impact Russia's productivity by depriving the country of essential knowledge for its key sectors and deterring cooperation between Russian and Western companies. In summary, we believe the sanctions did not have a substantial impact on the Russian economy, but they did exacerbate the macroeconomic challenges (particularly the drop in oil prices) that Russia was facing in 2014.

(2) Sanctions relief unlikely

Furthermore, we consider the likelihood of a relief from sanctions before March 2018 (presidential elections in Russia) to be very small due to domestic political constraints in the US, EU, and Russia. In the US, President Donald Trump is highly constrained in his ability to pursue rapprochement (if he were so inclined) due to the ongoing investigation into Russian hacking, contact between his close associates and the Kremlin during the campaign, and the president's potential obstruction of justice. Meanwhile, French elections did not result in a pro-Kremlin government, nor is this expected in Germany following elections there in September 2017. The EU is therefore likely to stick to the existing sanctions regime while the Minsk II ceasefire in Ukraine remains unimplemented. In Russia, the Kremlin is using the ongoing conflict and political instability in Ukraine to highlight the negative consequences of revolution as opposed to the status quo that Putin represents. The sanctions currently in place have a negligible effect on the Russian economy, and over time the Russian domestic producers have adapted to the food embargo. Therefore there is little incentive for the Kremlin to take steps for sanction relief.

The 2014 crisis hits inflation and the ruble more in comparison with the 2008-2009 crisis (% change)

	Oil price	Inflation	10y yields	MICEX Index	Lending (loans)	Unemployment	Exports	Imports	USD/RUB	REER
Jul-08 - Jul-09	-51.64	9.34	76.56	-29.56	-3.00	44.19	-43.78	-46.97	34.93	-6.96
Jul-14 - Jul-15	-44.62	167.96	14.72	20.98	-1.15	10.81	-40.88	-42.63	65.34	18.93

Source: Bloomberg, calculations ABNAMRO

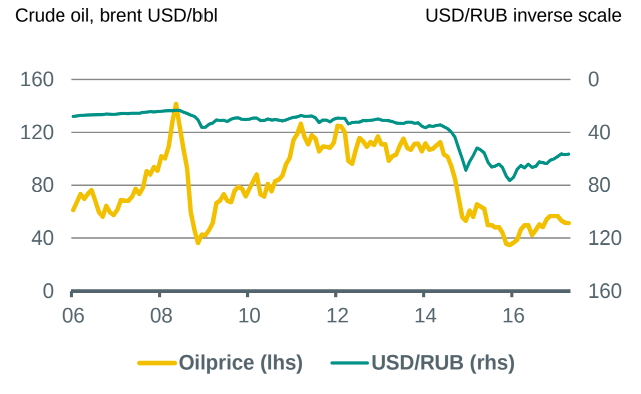
The ruble reacted directly to the imposed sanctions…

The currency depreciated from a quite steady level of around 35USD/RUB in the first half of 2014 to almost 80USD/RUB in December 2014 in the wake of a sudden ruble sell-off. We believe that the impact of the oil price does not fully explain the ruble's decline at the time given that the Russian currency dropped more substantially than oil prices. While many commodity-exporting emerging markets experienced a correction in their currency value during 2014/2015, the ruble's volatility at end-2014 was exceptional. The sanctions, in particular the immediate need for businesses to pay off their external debt before maturity and the flight of foreign currency out of the country, created a dollar shortage at the end of 2014.

… but other factors came into play during 2015

The USD/RUB sharply fluctuated in 2015, as other factors became more important. Since FX reserves were already trending down since 2013, the CBR took steps to free float the ruble in 2014. In late 2014, the CBR announced that it would only intervene in the currency market in exceptional cases, allowing the ruble act as an automatic adjustment mechanism. However, during the course of 2015 it appeared that the CBR had lost control as market speculation intensified. A further decline in oil prices in mid-2015 added to concerns of a deep economic recession. The CBR responded with an aggressive hike of 650 bp in December 2015 and other temporary measures to calm financial markets. The ruble has strengthened since 2016, helped by monetary tightening, higher oil prices and a more positive investor sentiment. Thus, while we believe that the sanctions added to overall negative sentiment in 2014, other factors took over in 2015/2016 and the effects of the sanctions where hence short-lived.

Ruble depreciated substantially…



Source: Thomson Reuters Datastream

Businesses were forced to repay foreign debts…

While the impact of sanctions on the ruble were limited, the financial sanctions did, in fact, generate a big capital outflow. Due to a ban on foreign borrowing with a maturity exceeding 30 days, many corporates were forced to make repayments on their external debt ahead of schedule because rolling over their foreign credit lines was no longer possible.

… portfolio investment was withdrawn from Russia…

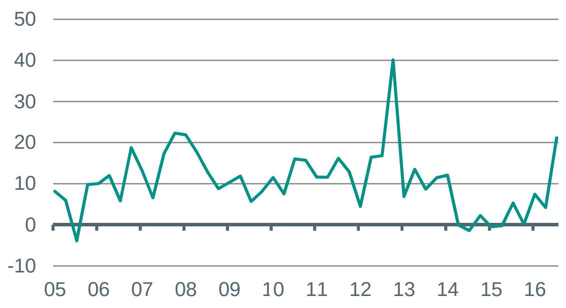
Portfolio flows turned negative in 2014, indicating that investors withdrew significant funds from Russia. The panic on the FX market at end-2014 was partly caused by the massive withdraw of portfolio investment. This, in turn, also added to a further withdrawal. Meanwhile, the downgrading in Q1 2015 of Russia's sovereign rating (mainly due to lower oil prices) contributed to the outflow, as it led to automatic sales of securities by institutional investors. The negative portfolio flows continued during 2015, but turned positive again in the first quarter of 2016.

… and foreign investors were less willing to invest in Russia…

Net FDI plunged during 2014 and actually turned negative in the third quarter. Before the introduction of the sanctions, around 80% of total FDI inflows where from EU member states. Investment in both sanctioned entities and non-sanctioned entities dropped due to the overall negative sentiment in Russia and concerns among Western banks of being fined if they were to (unknowingly) violate the sanctions. This worry become more pronounced in 2015 when BNP Paribas was fined USD 8.9bn for violating US sanctions against Sudan, Cuba, and Iran. FDI inflows recovered in 2016, rising from USD 7bn in 2015 to USD 33bn on the back of higher oil prices and improving investor sentiment, as well as the fact that Western banks found legal pathways to invest in Russia again. The balance of payments data released this week shows that net FDI inflows in the non-financial sector picked up sharply to $7.8bn in Q2 2017.

A drop in net FDI

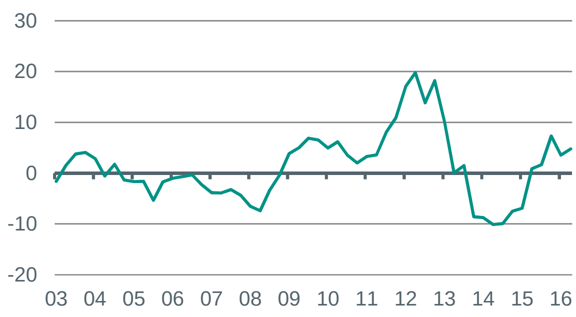
USD billions



Source: Bloomberg

Portfolio outflows turned negative

12 months rolling sum USD billions



Source: Bloomberg

… but over time Russia managed to keep its head above water

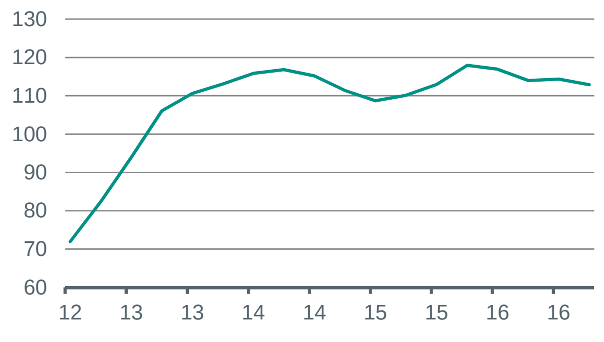
The forced foreign debt repayment, declining FDI and portfolio outflows, all intensified the dynamics of capital outflows. In 2014, capital outflow was over USD 151bn. However, the consequences of this dry-up of (foreign) capital were mitigated by effective policy implemented by the Russian government. In January 2015, the government announced a RUB 2.34tn (USD 35bn) spending plan, including a RUB 1tn bailout scheme for major banks and a further RUB 550bn to fund loans to businesses. While this helped to avert a financial crisis, it led to an adjustment in the total FX reserves (see graph below). In 2016, the Russian government successfully issued Eurobonds (which are not sanctioned) and used these funds to lend to sanctioned entities. Since Russia's government debt is low (12% of GDP in 2017), there is enough fiscal room for such constructions. As a consequence of the firm actions taken by the Russian government, credit to businesses remained stronger than during the 2008/2009 downturn. Non-performing loans ratios rose to around 9% in 2016 but this was slightly higher in 2009 (9.6%) and has more to do with the overall state of the economy than a lack of channels to (re)finance debt. With the financial crisis averted and oil prices increasing, capital outflows stabilised in 2015 when annual outflow reached USD 57bn (nearly one-third of the 2014 level). Around that same amount left Russia in 2016.

De-dollarisation has facilitated Russian economic nationalism

External private sector debt has decreased substantially, from almost USD 80bn at end-2013 to USD 35bn at end-2016. Russian entities were building their currency 'cushion' by reducing investment expenses, implementing austerity policies and continuing to sell off their foreign assets. All this enabled them to repay a significant part of their foreign debt. In view of this, we believe that the biggest hit already took place in 2014/2015, making the Russian economy less dependent on foreign capital.

Dollar capitalisation of the private sector has halted

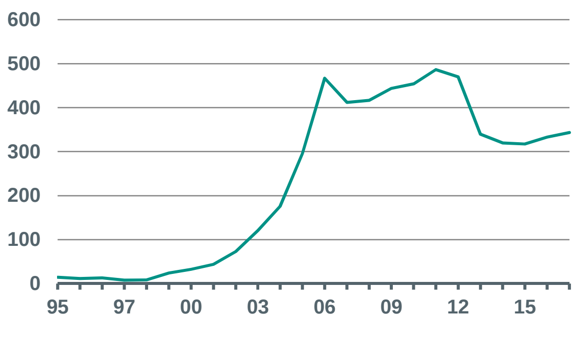
Foreign liabilities in USD billions



Source: Bloomberg

… and FX reserves dropped

USD billions



Source: EIU

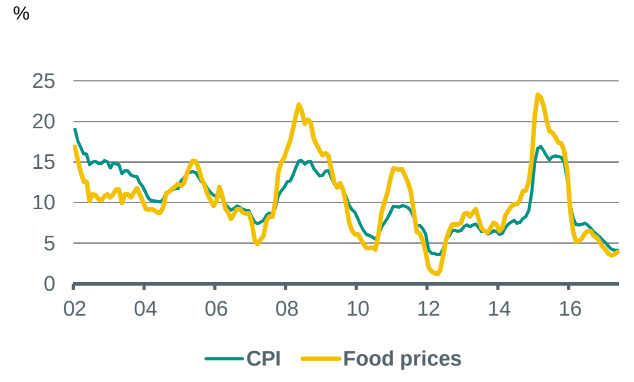
Sanctions and counter-sanctions had a negative effect on inflation…

Headline inflation increased sharply from mid-2014 to the beginning of 2015, from roughly 7.5% to nearly 17%. This was partly due to the higher import prices due to the sharp fall of the ruble at that time, but the counter-sanctions also played a role. The counter-sanctions imposed by Russia mainly targeted food products. The resulting market shortages, combined with under-developed domestic production and the high cost of importing food from alternative markets, drove up prices by as much as 23% directly after the counter-sanctions were announced. This is unusual given that when oil prices declined during the financial crisis in 2008, food prices also fell. Also, average world food prices declined (yoy) during the 2014-2016 period, while Russian food CPI increased.

… but inflation was tamed in 2016

With the help of state subsidies, domestic producers have substituted some of the banned food products. Meanwhile, food imports from non-sanctioning countries (Argentina, Brazil, China, Chile and Turkey) have increased over time. Due to these substitution effects and a good harvest in 2015-2016, Russian food prices have come down significantly in recent months, staying below 7% in 2017. This, together with a stronger currency, has also reduced headline inflation, which is approaching the CBR target of 4% (See also: Russia watch: Central bank cuts rate further). So while the (counter-)sanctions have had a direct impact on food price inflation in the short term, substitution effects and the firm monetary policy response by the CBR have brought (food) inflation down to a normal level.

Russia food prices push up inflation



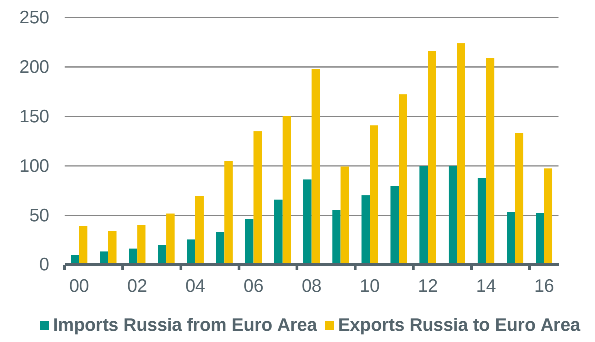
Source: Bloomberg

Counter-sanctions had no significant effect on imports or exports…

In 2013, around 50% of Russian exports were destined for the EU and around that same percentage of Russian imports were coming from the EU. Russian-US trade links were much smaller, accounting for 5.5% and 2.5% of exports and imports, respectively. The total value of trade with the EU declined from USD 286bn in 2014 to USD 191bn in 2016 (33%). However, this was mostly due to lower prices (i.e. oil prices), since trade with the EU in volume terms only declined by 4.5% in 2014. As is illustrated by the right-hand graph below, the share of EU trade in total trade remained fairly constant. While trade of specific products (such as food) declined, this has had little overall impact on the trade relationship.

Trade with the EU has declined since 2014…

EUR billions



Source: Thomson Reuters Datastream

… but the trade share with the EU remains constant

% of total imported and exported goods (value)

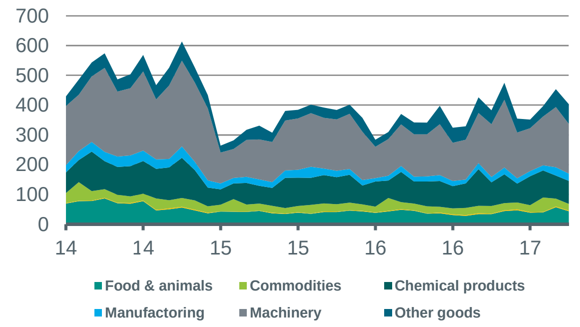
Source: IMF (Direction of Trade Statistics)

… nor on trade with the Netherlands

In the period Jan-April 2014, the value of Dutch exports to Russia amounted to EUR 2.07bn (1.40% of total Dutch exports). In the period Jan-April 2015, exports declined to EUR 1.26bn (0.90% of total exports). As seen in the left-hand graph below, exports of machinery and food products showed a particular decline. The latter can be explained by the counter-sanctions Russia imposed on agriproducts. Exports of cheese, vegetables and flowers decreased substantially. The fall of machinery exports can be largely explained by the poor economic conditions in Russia during 2015. However, since 2016 exports to Russia have strengthened in line with the overall recovery of the Russian economy. Dutch exports to Russia's neighbouring countries increased, and are resold on the Russian market. On average, this has increased transportation costs but helped exporters to maintain their market share.

Dutch exports to Russia declines

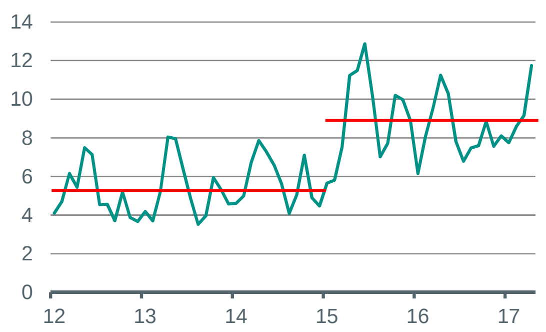
EUR millions



Source: CBS

Exports of food products to Latvia increases

EUR millions



Source: CBS

At present, the impact of the sanctions is negligible…

The effect of the sanctions on the currency, capital flows and inflation has waned over time. In addition, many of the worries that where present during 2014/2015 have abated over time. The CBR policy proved to be efficient and worries over manipulating the ruble and announcing stricter counter-sanctions have diminished. Furthermore, the crisis in Ukraine has been in a deadlock for three years now, without Russia's military meddling in any other neighbouring countries. Given this ‘status quo’, perceived risks have declined and investors are returning to the Russian market. Furthermore, with oil prices increasing, the economy once again returned to positive growth at end-2016. Over time, Russia’s financial sector and domestic producers have adapted to the (counter-)sanctions regime and, with no signs of relief from either the US or the EU, Russia considers the sanctions as the ‘new normal’.

… and new US sanctions will not change this...

In June 2017, the US Senate passed a bill to toughen sanctions against Russia. Although this bill mainly specifies the sanctions that are already in place, a clause also targets the Nord Stream 2 natural gas pipeline that provides energy to Europe. Amidst strong lobbying by EU Member States concerned about future energy security, it is deemed likely that this clause will be scrapped or watered down by the House of Representatives, which has yet to approve the bill. In the event that the bill were to pass, the new sanctions would have a negligible impact on the Russian economy.

… though in the long term, sanctions could negatively impact productivity

While the effect of sanctions has so far been limited, the long-term impact could be more severe as sanctions are likely to delay the modernisation of Russia’s oil industry. Indeed, several Western companies have pulled out of ventures with Russian partners. The Russian government has reacted by creating a state research and technology company that will focus on producing special drilling equipment. However, such modernisation projects require knowledge that must be acquired through many years of education and training. Russia is dealing with several structural problems due to negative demographics, a weak investment climate and a poor institutional environment with mediocre scores for corruption and rule of law. Furthermore, we believe that Russia’s pivot to Asia is advancing very slowly. The possibilities of obtaining capital and knowledge from the Asian market remains limited because of its lack of experience cooperating with Russia and undeveloped financial and technology markets (relative to the West).

Sanctions are likely to remain in place until at least March 2018

It currently appears unlikely that sanctions will be lifted before the end of 2017 due to domestic political circumstances in the US / EU as well as Russia. The prospect of US-Russian rapprochement under President Donald Trump is curbed by an ongoing investigation into obstruction of justice by the president for allegedly attempting to block an FBI probe into links between his administration and the Kremlin. Recently, Trump appears to have taken a more assertive public stance on Russia. It therefore remains uncertain how US-Russia relations will develop, also because of the apparent absence of a clear US foreign policy orientation on Russia. Regardless, the president’s ability to unilaterally approve sanction relief may also become more difficult going forward. If the aforementioned June 2017 Senate bill is also approved by the House of Representatives, Congressional approval would be required for any change to sanctions. Given Congressional reservations on overtures to Russia, this makes continuity of sanctions likely in the medium term.

Progression on Minsk II is lacklustre…

On 28 June 2017, the Council of the European Union extended EU sanctions on Russia by six months to January 2018. The EU has asserted that sanction relief is off the cards until the Minsk II ceasefire accord is implemented. That agreement states, among other things, that Russia is required to withdraw material support for the secessionist groups in the eastern Ukrainian provinces of Luhansk and Donetsk, and to enable Kiev to regain control of its border with Russia. Simultaneously, Ukraine's obligations include passing legislation to ensure a degree of autonomy for those provinces. Although several smaller Member States such as Greece, Hungary, and Slovenia have voiced their support for partial relief due to trade considerations, such steps are unlikely while Germany and France remain committed. At present it appears highly unlikely that any progress will be made on Minsk II during the remainder of this year. Violence in Eastern Ukraine along the line of contact has in fact increased in intensity and frequency over the past weeks. The government in Kiev has thus far been (and looks to remain) unable to enact legislation towards decentralisation and limited autonomy for the eastern regions. Even more concerning is the fact that the longer the conflict in the Donbass (the region encompassing Luhansk and Donetsk) lasts, the more problematic it will be to re-integrate it into wider Ukraine. Aside from the financial burden of being responsible for two war-torn regions, Russia's influence on local politics, and alienation with Kiev would provide opportunities for Moscow to influence and potentially destabilise Ukraine.

… and there is no incentive for the Kremlin to move forward…

For its part, Russia has also reneged on implementing its side of the Minsk II accord, including the suspension of support for secessionist groups. There appears to be very little reason for Russia to take the necessary de-escalatory steps towards a potential deal on sanction relief. Because the economic effects of sanctions are manageable, the Kremlin does not likely feel the necessity to compromise on pursuing domestic and international political objectives. The most important of these objectives is the upcoming presidential election scheduled for March 2018. The preservation of political stability has long been a key element of the Kremlin's efforts to ensure public support for President Vladimir Putin. As a result of the continuing conflict in the Donbass, Ukraine remains in political crisis and this example is keenly used by Russia to highlight the negative consequences of revolution. Sanctions by the West are also portrayed as attempting to deny Russia its rightful resurgence on the world stage, thereby rallying the population around the Kremlin. Russia is therefore happy to maintain the status quo, in the hope that long-term geopolitical changes – such as the potential emergence of a less anti-Russian government in Ukraine after 2019 elections – might lead to a deal that prevents loss of face.

…but a new roadmap for Minsk II implementation may be on the cards later…

The main obstacle to implementation is that there is no specific timeframe for steps to be taken by Ukraine and Russia, which has led to deadlock. While Kiev claims that it cannot enact decentralisation measures before Russia withdraws its material support for the secessionist groups in the Donbass, Moscow argues the opposite. Thus far, obstructionism by the Kremlin may have been motivated by its interest in maintaining influence over a destabilised Ukraine while awaiting elections in the US and several EU states in the hopes of more Russia-friendly governments taking office. However, President Trump is hamstrung by domestic investigations, while elections in France and the

Netherlands have not resulted in pro-Russia governments (nor is this expected to happen in Germany's September election). Russia might therefore feel more inclined to alter its position on Minsk II. However, given Russia's lack of immediate need for sanction relief and the undesirability of renegotiating Minsk with an outgoing German cabinet, any cautionary steps that do emerge are only likely to take place after German elections.

… in which concrete steps are directly linked to partial relief of the sanctions
Several elements would be required to facilitate implementation of Minsk II. Firstly, renegotiations to reform the deal's contradictory provisions and to add components that would increase interest by both Ukraine and Russia to implement their sides of the bargain. It has been suggested by regional analysts that concrete steps should be linked to 'carrots' from the EU and US. In the case of Russia, the West might offer relief of certain sanctions in exchange for implementation of each element of the Minsk II deal. Such partial relief would likely include a 'snapback' provision allowing the EU/US to reinstate sanctions swiftly in case of non-compliance. Similarly, Ukraine might be enticed to fulfil its obligations by the promise of (additional) financial and political support. Agreeing on a set roadmap and incentive-linked timeframe might facilitate a cycle of de-escalation and confidence building. A second crucial component for success is the inclusion of the US. This would end the separate bilateral negotiations between Washington and Moscow, thereby ensuring that all parties are aligned in a transparent and multilateral process.