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Russia's Response to Sanctions: How Western Sanctions Reshaped Political Economy in Russia

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Since August 2017, legislation allowing the imposition of a range of new sanctions against Russia has been passed by US lawmakers. Although not all this legislation has thus far been implemented by the president, Donald Trump, the mere threat of more draconian economic sanctions from the US created considerable uncertainty in Russia, especially after several high-profile Russian nationals were placed on the US Specially Designated Nationals (SDN) list in April of this year. Several senior officials and lawmakers in the US have also indicated a willingness to impose penalties on other countries that do not observe US sanctions.

To many observers, this escalation of sanctions by the US is an important development that could generate greater impact than the 'Ukraine sanctions', which were imposed by the US, the EU, and their allies in response to Russia's annexation of Crimea and subsequent involvement in the conflict in Eastern Ukraine in 2014. The 'Ukraine sanctions' – including the so-called sectoral sanctions that targeted Russia's oil, defence, and financial sectors – largely failed to cause policymakers in Russia to deviate from their foreign policy course since 2014. Understanding why the impact of sectoral sanctions was so modest can help us understand what type of impact the latest sanctions might have on Russia.

In this article, I show how Russia responded to the sectoral sanctions imposed as a result of the conflict in Ukraine in the summer of 2014. Based on the research undertaken as part of my recently-published book – *Russia's Response to Sanctions*[1] – I make four basic observations in this article.

First, when considering the impact Western sectoral sanctions had on political economy in Russia in the three-year period after they were put in place, I suggest that while sanctions caused some initial disruption, their impact on targeted sectors quickly subsided.

Second, I argue that the Russian authorities were able to utilize a range of tools and resources – many of which were readily available due to the specific characteristics of Russia's system of political economy – to cushion the targeted sectors from the worst effects of sanctions. In short, the strategic response of the Russian authorities to sanctions reduced their impact.

Third, sanctions and the Russian response resulted in a clear shift towards greater reliance on domestic resources – or 'Russification' – on the one hand, and towards a more multidirectional foreign economic policy that emphasizes closer relations with non-Western countries, on the other. While this process is far from complete, the direction of travel is clear: greater investment is taking place in building domestic capabilities in targeted sectors, and Russia is gradually shifting towards new non-Western sources of technology and capital.

[1] *Connolly, Richard (2018). Russia's Response to Sanctions. Cambridge University Press.*

Fourth, Russia's response to the 'Ukraine sanctions' can provide important insights into how the most recent wave of US sanctions is likely to affect Russia. I suggest that Russia is likely to employ similar tools to those that were used in response to the 'Ukraine sanctions' to reduce the impact of the new round of sanctions. While this might not necessarily be the most economically efficient solution to Russia's economic challenges, it will probably make Russia less vulnerable to external economic pressure, both now and in the future. In turn, this will enable Russia to continue to pursue an independent, or 'sovereign', foreign policy for the foreseeable future.

The Russian Response

Western leaders and officials were ultimately frustrated by the relatively modest degree of economic pain inflicted on Russia. This was because the Russian government did not remain passive as the Western sanctions regime evolved over the course of 2014. Instead, Russian officials employed techniques of economic statecraft of their own and formulated economic policies designed to reduce the impact of Western sanctions and to insulate the domestic economy from similar measures in the future.

The Russian response comprised three complementary and overlapping components:

1. the securitization of strategic areas of economic policy;
2. a concerted effort to support import substitution in strategic sectors of the economy; and
3. vigorous efforts to cultivate closer economic relations with non-Western countries, especially in Asia.

All three elements were evident in Russia's so-called counter-sanctions regime, which was introduced in August 2014 and targeted Western agricultural exports to Russia. Broadly speaking, the Russian strategic response, which was applied in all three of the sectors targeted by the US and its allies, was focused on enhancing Russia's economic sovereignty through state-directed efforts to boost Russia's domestic economic capabilities (i.e. import substitution and localization) and by diversifying Russia's foreign economic relations.

The Russian response was led by the state and utilized the considerable instruments available to Russia's policymakers. The already considerable influence of the Russian state in key sectors of the economy proved to be particularly significant because it enabled the state to react in a relatively coordinated fashion to Western sanctions using a range of financial, institutional, and diplomatic measures.

The Impact of Western Sanctions Since 2014

The impact of Western sanctions was not uniform, largely due to the fact that the adaptive measures formulated by Russia had varying levels of success.

The Energy Industry

Due to its strategic importance and because it is one of the most globally integrated sectors of the Russian economy, the Russian energy industry was also an obvious target for Western economic sanctions. In the summer of 2014, restrictions on access to capital and technology were imposed on Russian oil and gas companies. These tended to affect oil production the most, but the scope of the sanctions meant that some gas projects were also affected.

Technological sanctions focused on plans for the development of 'new frontier' oil deposits, both offshore in the Arctic and onshore in the shale-oil formations (such as the Bazhenov and Domanik formations in Western Siberia and the Urals), although they also affected technology used in enhanced recovery of oil in brownfield deposits. Financial restrictions also affected current operations of Russian energy firms. As a result, sanctions had the potential to reduce Russian oil production in the short term and more significantly in the future. Russia's ability to expand production of offshore natural gas and to increase its exports of liquefied natural gas (LNG) was also threatened.

Because of the crucial role that hydrocarbons play in the Russian economy, sanctions that threatened Russia's ability to extract hydrocarbons were described by senior officials as 'highly politicized' and 'a threat to national security'. To reduce Russian vulnerability to this threat, policymakers devised a dual policy of Russification and diversification. Russification involved the provision of support to the domestic oil and gas equipment industry in the government's wider import substitution strategy. This was accompanied by efforts to increase control over different aspects of the Russian energy industry, including exploration, oil services, and production. Diversification involved the acceleration of efforts by both the Russian government and by state-owned firms towards forging closer ties with non-Western sources of capital, technology, and demand for Russian energy.

Initially, the Russian energy industry experienced disruption and increased costs as a result of Western sanctions. This was especially apparent in the first few months after financial sanctions were imposed when several targeted Russian firms experienced difficulties dealing with the sudden stop of Western capital to large energy firms like Rosneft and Novatek. Several of the high-profile joint ventures with Western international oil companies (IOCs) were also frozen, with US firms being especially hard hit. Some Russian firms operating in hard-to-recover deposits also noted some difficulties in accessing the necessary technology.

Nevertheless, it is important not to exaggerate the impact of sanctions on the Russian energy industry, nor to expect that they will exert any significant impact in the future. The state's response to sanctions was comprehensive and sophisticated. A range of instruments – financial, institutional, and diplomatic – was used to cushion domestic energy firms from the immediate impact of sanctions and to change the trajectory of the industry's integration with the wider global economy.

From the Russian perspective, much was achieved in just three years. A determined effort to expand investment in the oil and gas equipment industry was gathering momentum. Alongside attempts to reinvigorate the domestic oil and gas equipment industry, rising imports of equipment from non-Western countries meant that the trend towards increasing reliance on Asian sources of equipment, already evident pre-2014, was resulting in a slow but steady reduction in Russian dependence on the West for technology. The substitution of technology has been accompanied by the steady increase in the use of non-Western sources of capital, with China leading the way in supplying capital to Russian energy projects on an increasingly large scale. Importantly, diplomatic resources were used to open up a closer gas trade relationship with China. Alongside Russia's emergence as China's single largest supplier of crude oil, the intensification of energy trade between the two countries means that Russia is moving closer to achieving the objectives stated in energy strategy documents published before sanctions were put in place.

The Defence Industry

Historically, the defence industry, or the 'military-industrial complex' (OPK, *oboronno-promyshlennyi kompleks*), has occupied an extremely important position within Russia's political economy. It is strategically important, in so far as it provides Russia with a large and relatively independent defence-industrial capability that enables it to supply its armed forces with a wide range of weaponry. It is also an important source of industrial employment and represents one of the few areas of technology-intensive manufacturing in which Russian firms are successful as exporters.

It is perhaps no exaggeration to state that Russia's defence industry is one of the most important components of its position as a power of global significance and one with the capacity to pursue interests that are times inimical to those of Western powers. It is, after all, the defence industry's ability to produce a wide range of sophisticated and effective weaponry – both conventional and nuclear – that furnishes Russia with the military capabilities that underpin its independent role in international politics. Without this capability, it would be difficult to maintain Russia's position in global affairs. This sentiment was expressed clearly by the Prime Minister, Dmitri Medvedev, who declared in 2015 that 'if we do not have effective armed forces, we will simply have no country.'

In the summer of 2014, Russian defence enterprises were restricted from accessing capital and technology from sender countries. Western sanctions were buttressed by a moratorium on the supply of defence-industrial equipment by Ukraine. Unlike the energy industry, where access to only specific items of technology was prohibited, a blanket ban on the export of items that might be used in military production was imposed. This included both final weapons systems, but also components and dual-use items that could be used to support defence-industrial activities. Consequently, sanctions by the West and Ukraine together carried the potential to disrupt defence-industrial production in Russia and, in turn, to disrupt Russia's domestic military modernization programme as well as its ability to export a high volume of weaponry.

As in the energy industry, the Russian response to the sanctions imposed on the defence industry consisted of a combination of Russification and diversification. In the OPK, Russification encompassed an ambitious import substitution programme that sought to replace prohibited components and weapons systems with domestically-produced analogues, including helicopter and ship engines. This was accompanied by efforts to intensify defence-industrial cooperation with several non-Western states, such as China and India.

Taken together, the Russian response to sanctions has the potential to practically eliminate large-scale domestic defence-industrial cooperation with Western and Ukrainian firms. If successful, this will reduce the OPK's vulnerability to sanctions in the future. Furthermore, efforts to cultivate closer defence-industrial ties with non-Western powers might support a wider foreign policy shift towards building closer ties with the 'non-West'. In this respect, the potential of Russian adaptive measures is as much political as economic. As in the energy industry, the process of adjustment and adaptation has been state-led, with the leadership using its control over institutional, financial, and diplomatic levers to minimize the intended impact of Western sanctions.

It is certainly true that Russia's defence industry experienced significant disruption as a result of Western and Ukrainian sanctions: most notably, reduced access to Western and Ukrainian components and defence-industrial equipment caused progress to slow in the procurement of surface ships for the navy and transport aircraft for the air force. However, the overall programme of military modernization, initiated in 2010, continued to proceed in a broadly positive fashion. As proved the case in the energy industry, the impact of sanctions on the Russian defence industry was not as bad as some initially feared. Adaptive measures taken by Russian policymakers after March 2014 created the conditions for gaps in supply to be filled and appeared to have reduced the industry's vulnerability to sanctions in the future. That defence-industrial production continued to grow was largely because the state's response to sanctions was comprehensive in scope, institutionally sophisticated, and utilized considerable financial resources.

Production facilities were upgraded so that engines for large warships and helicopters were produced by indigenous companies. Alongside the concerted effort to boost domestic production capabilities, the continued growth in the share of imported electronics from non-Western countries, especially China, reinforced the trend towards increasing reliance on Asian sources of equipment. A determined effort by leading Russian officials to strengthen defence-industrial cooperation with China and India also has the potential – albeit still unfulfilled – to take advantage of each countries' comparative advantages in defence production to build advanced new weapons systems.

As was observed in the energy industry, the Russian response to sanctions in the defence industry offers a vivid illustration of how countries targeted by sanctions can use the resources at their disposal to adapt to sanctions, and in doing so, moderate the impact that was intended by sender countries and use the opportunity to channel support to what policymakers consider to be strategically important industries. In this instance, a country that possessed one of the largest military-industrial complexes in the world, and which had a proven track record of producing a wide range of weapons to a relatively high standard, was able to adjust to sanctions and continue to pursue an ambitious programme of military modernization.

The key features of Russia's system of political economy made this possible. Enterprises either owned by, or close to, the state were at the forefront of nearly all the instances where adaptation has taken place. Moreover, a clear political commitment on the part of the country's leadership – essentially unchallenged by other social groups – towards strengthening the military and maintaining an independent and secure industrial base helped justify the sizable transfer of resources towards the OPK that formed part of the response to sanctions.

The Financial Sector

In the summer of 2014, some of Russia's most important financial organizations were restricted from accessing capital from Western countries, a *de facto* 'sudden stop' of access to external capital occurred. Although the role of sanctions should not be overplayed due to the much more important sharp decline in oil prices that took place at almost the same time, it was nevertheless true that sanctions created problems for targeted Russian firms and that the state needed to formulate a policy response. Once again – and as was the case in the energy and defence industries – the Russian policy response to financial sanctions comprised a mixture of measures intended to promote the simultaneous Russification and diversification of financial flows.

Prior to the imposition of sanctions, Russia's financial system had become progressively more integrated with the Western-dominated sections of the global financial system. Russian banks, in particular, relied on Western capital to finance their activities, as did a number of the large firms from the natural resources sector. While the relationship between foreign capital and the Russian economy was often turbulent – the structure of the Russian economy caused capital inflows to be highly correlated with developments in the global oil market – it is fair to say that finance was one of the most globally-integrated sectors of the Russian economy. Sanctions changed this. By contributing to sudden stop of capital that generated a considerable economic shock at the end of 2014, sanctions forced Russian policymakers to develop adaptive measures that changed the nature of the financial system's integration with the global economy.

Russification – as a response to financial sanctions – involved a number of initiatives, many of which are difficult to separate analytically from the response to the simultaneous decline in oil prices. Most notably, domestic, state-controlled sources of capital were used to fill the void created by the sudden stop of foreign capital inflows. Informal capital controls were also implemented to boost the repatriation of foreign currency from private and quasi-public entities and to reduce gross outflows of capital. With a view to the longer term, the authorities reduced the vulnerability of the financial system to the threat of further sanctions by creating a new national electronic payments system and by continuing to bolster the domestic banking system. The latter involved the removal of weak and financially risky banks while simultaneously providing capital to state-owned banks. One outcome of this process was that the state's influence over the domestic banking system rose.

Moves to reduce the vulnerability of the domestic financial system to external pressure were accompanied by efforts to seek out alternative sources of foreign capital, both through the cultivation of closer links with a number of non-Western economies and through state participation in the creation of new multilateral financial organizations with non-Western powers that might be used to finance investment in the future.

As was the case in the other two sectors discussed previously, the process of adaptation to sanctions was overwhelmingly state-led, with the leadership utilizing a range of institutional, financial, and diplomatic tools to minimize the intended impact of Western sanctions and to begin the process of forging a new relationship with the global economy. While it would be exaggeration to state that Russia's response created anything like absolute immunity from developments in the global financial system, it is true that the Russian financial system is less vulnerable than it was in early 2014. Indeed, by the end of 2017, Elvira Nabiullina, the head of the Central Bank of Russia, felt emboldened enough to state that in general, the immunity of the financial system to various negative decisions that could be made is now higher than it was three years ago.

The impact of sanctions on the financial system was considerable, albeit difficult to estimate in precise terms due to the complicating effect of the sudden and sharp fall in oil prices that occurred alongside sanctions. In the short term, at least, financial sanctions appeared to generate the most pain. However, as in the energy and defence industries, the Russian policy response moderated the impact of sanctions. Adaptive measures taken by policymakers after 2014 created the conditions for a more self-reliant financial system. In doing so, they seemed to have reduced the financial system's vulnerability to any expansion of sanctions in the future.

To be sure, the Russian financial system continued to exhibit many of the problems identified as existing before sanctions were put in place. The banking system remained dominated by state-owned entities, and sources of long-term capital were few and far between. Moreover, relatively scarce capital continued to be allocated to entities with closer links to the state. Nevertheless, Russia did not experience a full-blown credit crunch. Through the deployment of focused state resources, politically and socially important firms continued to access capital. The fact that this occurred without accessing significant new sources of external capital from non-Western sources was also noteworthy.

Implications for the Latest Round of US Sanctions

To sum up, the sanctions imposed by Western powers and their allies in the spring and summer of 2014 exerted a powerful influence over the subsequent evolution of political economy in Russia. After nearly two and half decades of ever-closer integration with the global economy – especially with Western countries – sanctions caused policymakers in Russia to reassess the nature of the country's relationship with the global economy. They did not, however, turn to Soviet-era aspirations to autarky. Instead, significant efforts were made to build a more secure and durable system of political economy based on the development of domestic capabilities in 'strategic' (as defined by Russian policymakers) industries as well as by cultivating closer ties with alternative sources of technology and capital from outside the West and its allies. In formulating this response, policymakers reduced the impact that sanctions had upon the functioning and performance of the Russian economy, which in turn alleviated the economic and political pressure that Western powers hoped might cause Russia to modify its policies towards Crimea and Ukraine.

What, then, does Russia's response to sanctions in 2014 tell us about the country's ability to respond to the latest round of sanctions imposed by the United States over the past year?

The most obvious observation is that Russian policymakers will not remain passive as the scope and severity of sanctions are increased. Every escalation will result in the formulation of further adaptive measures. These need not involve direct 'counter-sanctions' that target firms in sender states. Russia's response to the US sanctions in April and May demonstrated very clearly the reluctance of policymakers to engage in a tit-for-tat sanctions strategy with one of the world's largest economic powers. Instead, the adaptive measures will be designed to reduce the impact of sanctions in a way that promotes key sectors of the domestic economy, maintains links with the global economy, and preserves Russian foreign policy independence.

The global context is also important. Unlike the Cold War, when the Soviet Union spent most of the period under some form of Western economic sanctions, Russia's post-2014 experience demonstrates clearly that there exists today a wide range of alternative sources of technology and capital. To be sure, the alternatives are not always comparable in quality and/or price to Western analogues. But the gap has narrowed in recent decades, and the fact that alternatives exist – even if suboptimal from a purely economic point of view – means that any reduction in economic efficiency caused by sanctions can be a price worth paying for a country that is intent on maintaining a sovereign and independent foreign policy.

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