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NEW SANCTIONS AGAINST RUSSIA DUE TO THE WAR IN UKRAINE

Framework, effects, possibilities

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SUMMARY

In this discussion paper, the Russian economist Vladislav Inozemtsev makes the following proposals for dealing with Russia:

1. Realign sanctions to cut off Russia's supply of thousands of goods, components and spare parts not produced in the country itself to damage the national economy with economic 'high-precision weapons' instead of 'area bombardment' in the form of an energy embargo.
2. As long as the EU continues to import fossil fuels from Russia, they should be subject to a special levy, the proceeds of which will be made available to Ukraine as a victim of the Russian attack and a future member of the European Union.
3. Treating President Putin and leading Russian officials and generals as war criminals and establishing an international war crimes tribunal to deal with Russian atrocities in Ukraine. This can bring about a radical delegitimization of the Russian leadership at the national and international levels.

In response to the Russian invasion of Ukraine, Western governments have imposed dozens of sanctions against Russia in recent months. Most of them aim at limiting the amount of money at the disposal of Russian authorities (the freezing of Central Bank reserves, the ban on Russian banks using their dollar accounts, and the highly controversial possibility of an import ban on Russian oil and gas), or at denying Russian consumers access to certain goods and services (such as the closure of European and North American airspace to Russian airlines, of Western stores and department stores in the country, and the ban on exports of luxury goods to Russia).

The main argument of this paper is that the impact of these measures on Russia will probably be much smaller than widely assumed. Even with half or even a third of the revenue from oil and gas exports, Russia can still sustain itself economically.

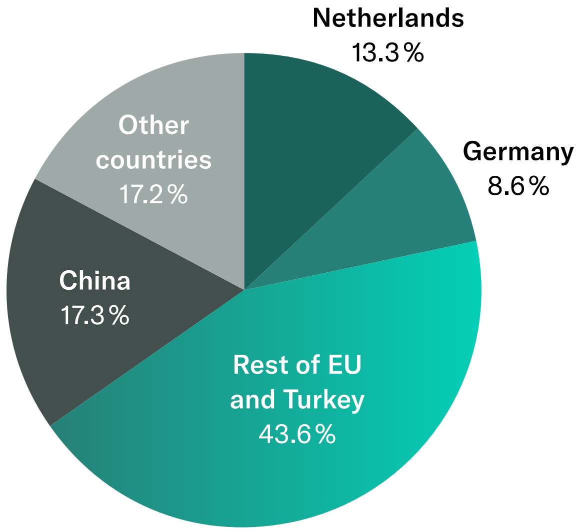
The crucial thing is to stop Russia's imports from the West, with a particular focus on industrial equipment, intermediate products, and any components and spare parts. Both Russian industry and the service sector depend on imports, so even a small drop in supplies will hurt the economy more than, say, a ban of Western oil imports from Russia.

However, the EU and US need to develop a mechanism that generates aid to Ukraine from imports from Russia. As long as it continues to import fossil fuel from Russia, Europe should impose a surcharge on them, which would go into a reconstruction fund for Ukraine. And it should not only sanction Russian oligarchs but allocate parts of their wealth to this fund. Those who participate could see their sanctions lifted in return. The sanctions should be much more onerous on Russia than on the West.

New sanctions against Russia due to the war in Ukraine – Framework, effects, possibilities

Back in 2014, the late US Senator and Republican candidate in the 2008 presidential election, John McCain, described Russia as a “gas station disguised as a country.” While the Russian economy has diversified over the past twenty years, his comparison holds true to this day in the sense that 35 percent of the Russian state budget is still made up of so-called hydrocarbon revenues. This figure is highly variable; in 2020 it was at a low of 27.96 percent, and at its peak in 2014 it was 51.27 percent, but the share of oil and gas revenues in the Russian budget has never depended as much on economic modernization as on fluctuations in the price of oil. Much-vaunted intentions to “get rid of oil dependence” have been expressed by Russian officials since the early 2000s, but they are mainly just words. And many experts claim that the actual share of state revenues from the energy sector is three to eight percentage points higher than the official figures.

It should also be remembered that Russia is dependent not only on oil and gas exports in general, but also on a number of specific major customers. In 2021, total revenues from oil, oil products, natural gas and coal reached US-$267 billion, exceeding the 2020 revenues by a breathtaking 59.9 percent. Germany accounted for about 8.6 percent of all revenues, the Netherlands for 13.3 percent and China for 17.3 percent. Overall, 64 to 67 percent of Russian energy exports went to EU countries and Turkey. Thus, a sharp drop in imports in Europe would hit Russia hard. In addition, Russian supply routes are not particularly flexible: 83 percent of natural gas is transported by pipeline, while liquefied natural gas shipments account for only a small share. Deliveries of Russian oil and oil products tend to be made by sea, so the problem here is less severe.



Major customers:
Russia’s total revenues from oil, oil products, natural gas and coal in 2021 in US-$ (total: $267 billion).

All this means that Russia is dependent not only on exports of its hydrocarbons, but also on the revenues that these exports generate to the “greater European area”, i.e. to the EU, Britain, Turkey and Switzerland. Until now, Moscow has been sure of its European customers, since Europe has been buying more and more Russian energy since the end of the 1970s and has increased its imports from Russia even in recent years, although there has been repeated talk about “diversification” of energy supplies. I have already pointed out several times that this trend is more dangerous for Russia than for Europe, since Europe’s share of Russian energy exports is about twice as high as Russia’s share of European energy imports. Before the Russian attack on Ukraine began, Europe bought about 25 percent of its oil and 45 percent of its imported natural gas from Russia, while Russia sends 56 percent of its oil and 77 percent of its natural gas to Europe.

Therefore, it is easier for European countries to figure out how to get by with less supplies from Russia than it is for Russia to implement an “energy blockade” of Europe. The only reaction from Moscow so far has been its demand to have Russian gas supplies paid in rubles, which was later replaced by a complicated procedure in which Gazprombank benefits by being the financial service provider responsible for the exchange of euros/dollars into rubles.

That brings us to the current situation, which led to the Russian attack on Ukraine on the morning of February 24. For years, critics of Putin’s regime had argued that sanctions against Russia should be extended to include energy trade, but that was always considered taboo, even after Russia invaded and annexed Crimea. Both the US and the EU then imposed sanctions only to limit Russia’s ability to develop new oil and gas fields, especially in the far north and offshore. But after the 2022 invasion of Ukraine, the situation changed. First, the US and Canada blocked all Russian oil, gas and coal exports; a little later, Britain announced that it would stop all oil imports from Russia by the end of 2022 and would stop buying Russian natural gas from 2024.

A heated debate about a ban on Russian oil and gas began in the European Union in early April and is ongoing at this paper’s publication. In the meantime, a coal embargo with a six-month transition period has been decided, while an oil embargo has so far failed due to Hungary’s opposition. An import ban on Russian gas remains controversial, with massive opposition from companies and trade unions, particularly in Germany and Austria. Nevertheless, it remains the EU’s declared intention to become independent of Russian energy imports sooner rather than later. This will be achieved, among other things, by the expansion of liquefied natural gas and the accelerated development of renewable energies and measures to increase energy efficiency.

> **“Moscow has been sure of its European customers: Europe’s share of Russian energy exports is about twice as high as Russia’s share of European energy imports.”**

How determined is the decision of the West and what are the consequences for Russia?

First of all, 2021 was a very successful year for the Russian oil and gas sectors. I am focusing on these here partly because coal exports represent a much smaller share than oil and gas ($17.6 billion for coal in 2021 compared to $236 billion for oil and gas), and partly because Russian coal is more likely to be shipped to Asia than to Europe (129 million tons in 2021 to Asia compared to 54 million tons to Europe). The volume of oil exports decreased by 3.8 percent, while gas increased by 3.2 percent. Both together generated about 65 percent additional revenue for Russia. In my opinion, the crisis on the European natural gas market was caused mainly by EU policy, but was later also influenced by market manipulation by Gazprom. All this led to a six-fold increase in gas prices in the last 12 months.

> **“It is incomprehensible to me how a switch from long-term contracts to spot pricing could be pushed ahead without a common EU line towards gas exporting countries and without building up strategic gas reserves.”**

It is incomprehensible to me how a switch from long-term contracts to spot pricing could be pushed ahead without a common EU line towards gas exporting countries and without building up strategic gas reserves to be able to achieve price equalization or at least introducing common guidelines on gas storage facilities, some of which belonged to Gazprom until a few days ago. Until the Russian attack on Ukraine began, “hydrocarbon revenues” in the Russian state budget for 2022 were beating all records, averaging 20 percent higher than in the previous year. But then suddenly everything changed.

The drop in Russian oil exports after February 24 seems dramatic, but it is too early to forecast its true extent and dynamics. According to various estimates, in the week of March 17-23, daily exports fell from about 8 million barrels per day in 2021 to just 3.63 million barrels per day. The drop was due to the decline in demand from Europe as well as the US ban on purchases of Russian hydrocarbons, but also to the sharp increase in sea freight costs, which had risen three to six times. This trend is set to continue in the coming months. Russia responded by attempting to diversify and is now exporting more oil to China and especially India (which has already been criticized by the U.S. for expanding its trade relations with Russia and its refusal to condemn the war in Ukraine).

In return, Moscow is offering hefty discounts on its blend of Urals crude, which was $5-6 per barrel cheaper than Brent in early February and cost about $30 per barrel less at the end of March. In addition, Russian oil tankers are increasingly trying to turn off their tracking devices, making it impossible to determine their destination port. Despite all that, Russian hydrocarbon revenues are probably higher than they were in the first quarter of 2021 because the average price of oil has increased by about 45 percent since then. The same is true for natural gas, where Gazprom expects record revenues in 2022 as well. In total, $321 billion in oil and gas revenues are forecast for this year, a 35 percent increase over 2021.

Will Russia stumble without energy exports?

Much less obvious than these market developments is the degree of Russian dependence on oil and gas revenues. Western politicians are of course right when they claim that the Russian government would be bankrupt if these revenues dried up. But to paint a realistic picture, several other points must be considered.

First, Russia's foreign trade has been very balanced for years, averaging a surplus of more than $172 billion per year for the period 2012 – 2021. Imports have averaged about $252.8 billion in the process, so even a 40 percent drop in revenues would not threaten import viability. Moreover, Russian experts believe that 2022 will bring the largest trade surplus in the country's history, as imports could drop by as much as 40 percent as many ties between Russia and the rest of the world are cut. In addition, capital flight from Russia averaged $57.9 billion per year in the above period and will fall by about 75 percent this year. Thus, the balance will become even more stable. However, Russia's Central Bank keeps the statistics on capital flight in February and March under lock and key. Therefore, even a halving of oil and gas revenues will not upset the Russian economy in the short term.

Second. Even though much of the oil and gas revenue goes to Russia's social welfare system and military and security services, I would not say that these sectors are suffering from cash shortages at the moment. On April 1, the Russian government increased pensions by 8.6 percent and announced at least two more increases for this year. With the Central Bank successfully restoring pre-crisis exchange rates and announcing the abolition of the 12 percent commission on dollar purchases on April 11 and the resumption of sales of foreign currency to the public from April 18, but without access to much of its hard currency reserves, the government seems to be

> **“ The direct damage to Russia from the invasion of Ukraine is not great enough to bring about an end to the war of aggression. President Putin has never been particularly concerned about the economic development of his country or the welfare of its people. ”**

ramping up domestic borrowing without worrying too much about possible inflation. These bonds could be as much as 3 – 4 trillion rubles ($40 – 50 billion) before the end of this year, which is more than enough to pay off all the necessary spending.

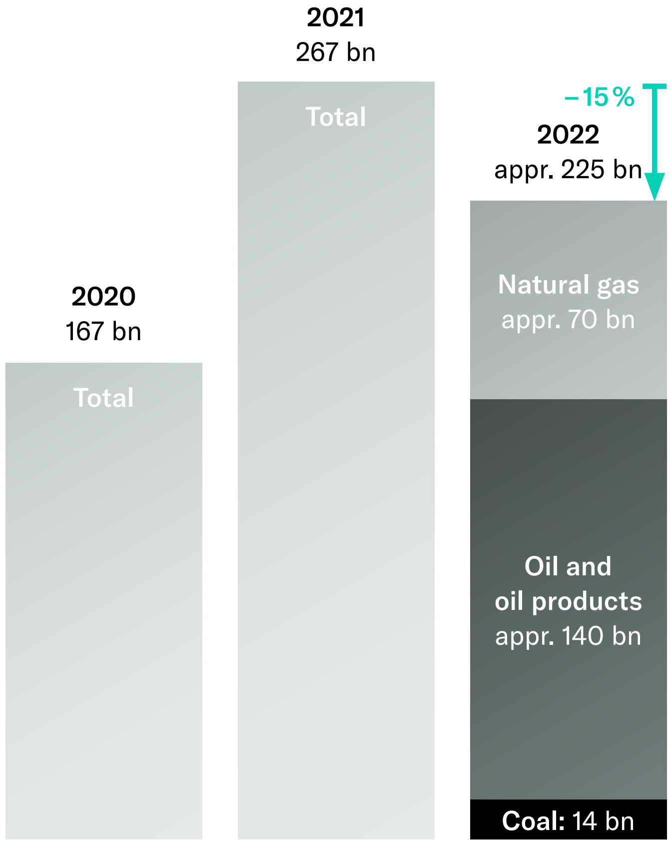
Third, I would argue that the direct damage to Russia from the invasion of Ukraine is not great enough to bring about an end to the war of aggression. Even if Ukrainian estimates of Russian casualties over the past month and a half are believed, and the total damage of all weapons and equipment destroyed is over $10 billion, that is only about a week's worth of export revenue. In my estimation, Russia may be losing the war on the battlefield, but not on the economic front. Be that as it may, I do not believe that President Putin, who has never been particularly concerned about the economic development of his country or the welfare of its people, will change his aggressive policy purely for financial considerations.

How are Western oil and gas sanctions affecting the Russian economy?

I would say they could be significant, but not decisive. Assuming a worst-case scenario, if the EU reduces its gas imports by 50 percent by the end of the year, Russia will lose about $75 billion of its total export revenues. Still, about $60 billion will flow to Russia from China and Turkey, and about one-third of the lost European oil imports will be replaced by tanker shipments to new markets, where Russian energy will be sold at a 20 to 40 percent discount. Accordingly, I expect Russia to receive about $70 billion in annual revenues from exports of about 160 billion cubic meters of natural gas. Oil and petroleum products revenues will decline to $140 billion, assuming the average price of oil remains at about 100 dollars per barrel. And revenues from coal exports will slowly decline to $14 billion, with about 200 million tons exported. Russia's total revenues from energy exports will drop to $225 billion, about 15 percent compared to 2021.

I would like to emphasize again that this is the worst-case scenario, taking into account all restrictions already in place by Western countries. This change is in no way critical for Russia's solvency or for its state budget. In the case of the latter, one should also consider that the exchange rate is currently over 100 rubles per dollar. This could further offset any losses by the end of the year because the tariffs levied in dollars mean much higher revenues when converted into rubles.

If one imagines the EU, the UK and the US completely stopping imports of Russian oil and gas by the end of 2022, the impact would be much greater and export revenues would fall by $140 – 170 billion. However, even in this case, I do not foresee a financial collapse for Russia. Even before the sanctions were imposed, the Russian Central Bank was not acting like a normal central bank: the European Central Bank's gold and foreign exchange reserves account for 11 percent of its total assets — in Russia, the share was 81.3 percent at the end of 2020.



Estimated revenue from Russia's energy exports in 2022, compared to the previous years, in US-$, assuming an average oil price of $100 per barrel.

At the time, the central bank in Moscow was barely investing in the Russian government's federal bonds (called OFZ or Federal Debt Bonds), but it could increase these investments by 5 to 6 percent of Russia's GDP, or to 8 to 9 trillion rubles (about $100 billion), without problems. If this money goes into the pension system or is used to raise wages, this would have little impact on inflation: it is expected to be 20 to 30 percent in 2022 anyway, so these additional bonds would add at most another 3 to 4 percentage points. The government would agree to such a measure immediately and thus be able to solve its budget bottlenecks at least this year.

At the same time, I expect Russia to direct its oil and gas supplies more toward Asia if it is squeezed out of the European market. While gas exports to China through the Power of Siberia pipeline were about 4 billion cubic meters in 2020, the pipeline will reach its full capacity of 38 billion cubic meters per year in 2025, with much of the liquefied natural gas supply also diverted to China. India, which currently receives about 2 percent of its massive oil imports from Russia, may receive the largest increase in Russian oil supplies in 2022. In contrast, pipeline-bound Russian gas exports to Europe cannot be diverted to other markets in the short term. This requires a massive expansion of Russian LNG capacity. The European embargo means that the EU and other countries that reject Russian energy supplies would have to buy more oil from the Middle East and Africa and LNG from the U.S. and the Asian Pacific region. This will create new market gaps that will be filled, though not completely, by Russian energy suppliers.

Therefore, it is almost impossible in the current situation to eliminate Russian energy to a large extent from global markets unless a binding United Nations embargo is imposed on all Russian exports, as was the case against Iraq in 1990. So far, however, this is completely unrealistic. While a Western embargo would, of course, deprive Moscow of a substantial part of its export revenues, it would hardly plunge Russia into an economic catastrophe, even if many analysts are convinced of the opposite. In my estimation, Russia currently has sufficient resources to survive an EU energy embargo for at least two years. Therefore, sanctions alone will not bring an end to the war in Ukraine.

> **“It’s almost impossible in the current situation to eliminate Russian energy to a large extent from global markets.”**

The focus should be on high-tech products

What else besides an oil and gas embargo can inflict sensitive damage on Russia? In my view, it would be much more painful to cut Russia off from European export goods, since the country itself not only produces few finished products, but also has to import intermediate products. Up to 85 percent of Russian companies use Western-produced components. Russian farmers import seeds, fodder and even eggs from Turkish chicken farms. Not to mention pharmaceutical ingredients, semiconductors and high-tech products. Even refill cartridges made by international printer manufacturers are not produced in Russia. If Western governments join Japan, Korea and Taiwan in imposing a full export ban on Russia, the economic damage would be immense. The leading “national” car manufacturer AvtoVAZ, for example, had to stop production on April 4 because no more imported electrical components were available for its latest models. Russian politicians are even discussing a reintroduction of the Soviet Lada models, which do without such technology.

The entire production in Russia would be affected by such an embargo. China alone would not be able to save the situation, because Beijing is also at least partially dependent on high-tech from the West. The damage to the West, on the other hand, would be minor because the Russian market is relatively insignificant for major international corporations (rare exceptions are Volkswagen, which produced 171,000 vehicles at its plants in Kaluga and Nizhny Novgorod in 2021, about 3.5 percent of total global production, or French supermarket chain Auchan, which made 9.7 percent of its gross sales in Russia in 2020). Building up domestic production of the goods it currently imports from Europe, Japan or the U.S. will also be difficult in the next five to ten years. And while the entire Russian oil and gas industry employs less than one million people, at least 15 times as many jobs are at stake in the industries that would be affected by shortages of components from the West.

In my view, the high-tech sector is the most fragile industry in Russia, even though it has become much more advanced and customer-centric in the last decade. This industry is totally dependent on technology and software from the West. If Western countries were to prohibit their high-tech companies from providing Russian users with updates to their operating systems and new applications for mobile devices, or from renewing license agreements for the software of banks and financial service providers, the impact on the country would be immense – because digitalization has taken over almost all spheres of life, and people rely on modern technology every day.

Russia also does not have a "trusted root certificate authority" and fully depends on international providers to issue SSL certificates for Russian corporate websites. Revoking an SSL certificate immediately ends secure data exchange. This would hinder bank transactions much more than the requirement to keep certain accounts only in dollars or the exclusion from the SWIFT payment system. The Kremlin has been speculating about the introduction of an "autonomous" Russian Internet for so long that I think it is time to show the Russians what that would look like in practice. I would go so far as to say that this move alone is likely to cost Russia up to 15 percent of its GDP in the first quarter after implementation.

It's true that much of Russia's export revenues and government revenues come from fossil fuel exports. But crucially, these revenues are drastically devalued when you are no longer allowed to buy what you want. That is why the most painful sanctions for Russia are not on its exports but on its imports.

“ In my view, the high-tech sector is the most fragile industry in Russia, even though it has become much more advanced and customer-centric in the last decade. ”

But now comes the most important question, namely how and in what way Western sanctions influence the decision-making processes in the Kremlin. For a while, Western politicians took the approach that only those directly responsible for human rights or international law violations should be sanctioned. This was the prevailing view in recent years, when relatively few individuals or companies were on the sanctions list. For the past eight years, the results of this strategy have been rather unimpressive.

The 2022 sanctions list is distinctive in that it targets a broader range of individuals: almost the entire Russian political elite and even, for the first time, President Putin himself; dozens of super-rich Russians who appear to have nothing to do with the atrocities in Ukraine; and, of course, millions of innocent citizens who can no longer travel abroad or use Western goods and services and, more importantly, risk losing their jobs or income to an impending recession and rising consumer prices. This, of course, is progress because prior to 2022, sanctions had little impact in Russia itself, except for those imposed by the Russian government, which banned the import of European and American foodstuffs in retaliation for Western restrictions.

The current sanctions seem to me to be effective enough to inflict serious damage on the Russian economy, which will also be felt by the majority of the Russian population. Nevertheless, I have no hope that people will rise up against their government because of economic hardships. Modern Russians are extreme individualists and when they get into financial difficulties, they try to get out of them individually.

> “Russia’s current electoral system prevents any change. Mass protests are less likely. I don’t think Putin will lose the 2024 election.”

Many years ago, I tried to explain why collective action no longer works in Russia, and nothing has changed since then.[1] Not only in Russia, but everywhere in the former Soviet Union have desolate economic conditions failed to trigger popular movements dangerous to the governments (the only exception is Kazakhstan in January 2022, but even that is due to much more complex causes). The protests in Russia in 2011/2012, 2018, and 2021 were led by successful young people. But this social group was most numerous in the wave of emigration that followed the Russian attack on Ukraine, making mass protests again less likely. Russia’s current electoral system prevents any change, so the sanctions are unlikely to have an impact on the political elite in the form of manifestations of popular will on the streets or in ballot stations. Moreover, relentless Kremlin propaganda is turning Russia into a quasi-fascist society and the war in Ukraine has led to a certain sense of national togetherness that tends to unite the country and the elites in dealing with the sanctions.

As for the reactions of the super-rich Russians, sometimes referred to as “oligarchs”, I have no hope. Under the current regime, Russian businessmen have no political influence. They can lobby for their business interests and take advantage of the Kremlin in competition with their rivals, but they have no say over Putin’s political decisions and cannot. Mikhail Fridman put this quite correctly in his recent interview with Bloomberg.[2] In any case, the “oligarchs” have neither influence over nor access to Putin that would allow them to bring about significant political change in Russia.

Therefore, I have little hope that democracy will return to Russia anytime soon. The only “crossroads” on the horizon is the 2024 presidential election, but a real danger for Putin can only arise if the Russian economy collapses and if its army is devastated in Ukraine. Russia would have to be expelled from the United Nations and obligated to pay half a trillion dollars in reparations to Ukraine.

Unless all of that comes together, I don’t think Putin will lose the 2024 election. Actually, the rise in emigration has only left the regime stronger since the anti-Putin protests of 2011/2012. Notions of national superiority and a declaration of war on the whole world to be “truly sovereign” dominate the agenda of a country that is a perfect example of fascism in the 21st century. There is much to suggest that most of Russian society will never rise up against their masters. No matter what is done to them. The sanctions may destroy Russia’s inefficient economy, but they will do nothing to the outdated form of society.

1 https://www.monde-diplomatique.fr/2010/10/INOZEMTSEV/19776

2 https://www.bloomberg.com/news/features/2022-03-17/broke-russian-oligarch-fridman-says-sanctioned-billionaires-can-t-sway-putin

What are the recommendations for European decision-makers on sanctions against Russia?

Here I would like to make three points.

1. Since Russia appears to be able to meet its expenses and engage in foreign trade for at least two years despite all conceivable sanctions by the West against its oil and gas industry, I would redirect the sanctions mainly to Russia's domestic economy. Here I would closely analyze the Russian economic situation and identify bottlenecks where production or supply chains are most dependent on imported goods, spare parts or technology. The more dependent the Russian economy is on imports in some areas, the more sanctions should target precisely those areas.

   This should be done according to the same principle that Western armies have followed for decades: do the most damage with the least amount of effort using high-precision weapons. This strategy will take time and require the development and deployment of skills, but it will pay off. It would be the most effective tool for destroying the Russian economy and creating civil disobedience or a split in the elites that would open the way to regime change.

2. Western policymakers should agree that, from both a foreign policy and domestic perspective, a Russian military defeat in Ukraine and a subsequent successful reconstruction of the Ukrainian economy, as well as its integration into the European Union, are far more important than Russia's economic development and the well-being of its people. In an indoctrinated society like Russia, more attention is always paid to the failure of its neighbor than to its own success. To make Ukraine an attractive model for success, a European Reconstruction Fund should be established for the country. As part of its financing, a targeted condition on the import of Russian energy sources could be introduced, which would flush fixed amounts per barrel of Russian oil or per thousand cubic meters of gas into the fund.[3]

3. Third, it is time to recognize that sanctions alone will not end the war in Ukraine. Recent events have revealed the unimaginable hatred, cruelty, and ignorance that have hitherto lain dormant in Russian society. President Putin is now correctly labeled a war criminal and will never accept the existence of a sovereign and pro-European Ukraine. Therefore, I think the West should focus on bringing about regime change in Russia and sowing internal strife in the Kremlin that will ultimately lead to Putin's removal.

   To this end, a war crimes tribunal should also be established for Ukraine, similar to the tribunals for the former Yugoslavia and Rwanda. President Putin, Defense Minister Sergei Shoigu, and the Chief of General Staff Valery Gerasimov, as well as dozens of military commanders who led brutal attacks on civilian targets in Ukraine, stormed Ukrainian cities, ordered the use of weapons prohibited by international treaties, and ordered mass executions of Ukrainian civilians, should be charged with war crimes.

   For these reasons, according to Carla del Ponte, who should be familiar with them, an international arrest warrant should be issued against Putin. This would be similar to what happened in Yugoslavia in 1999, when such an arrest warrant was issued against then-President Slobodan Milošević, also during his tenure as head of state. The extradition to The Hague of Putin and officials and generals responsible for the atrocities in Ukraine should be a condition for the lifting of all sanctions imposed on Russia since February 24, 2022. This could lead to a split in the Kremlin's inner circle, as the future of many high-ranking politicians and generals becomes increasingly uncertain, while Putin is losing his mind more and more, to say the least.

3 For more details, see:
Inozemtsev, Vladislav: "The Milošević Option"
in: International Politics, 2022, May–June, pp. 49–53.

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