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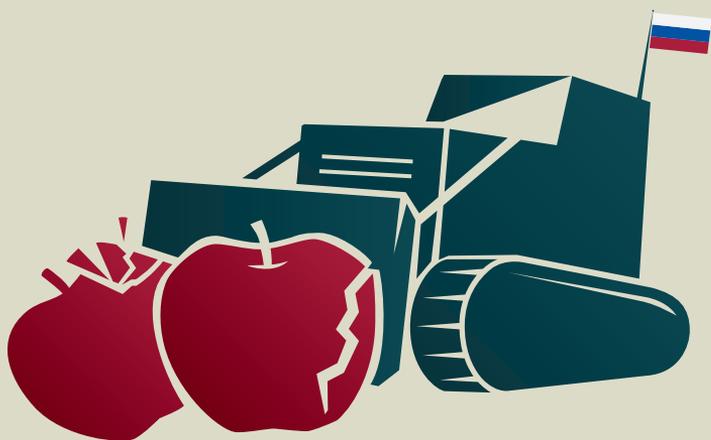
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S A N C T I O N S

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Assessing the Damage,  
Scrutinising Adaptation and Evasion





# **RUSSIA UNDER SANCTIONS:**

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Scrutinising Adaptation and Evasion



The Polish Institute of International Affairs

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Scrutinising Adaptation and Evasion

Stanislav Secrieru

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# EXECUTIVE SUMMARY

For a year and a half, Russia has been living under sanctions. The restrictive measures were imposed as a response to its continued violation of Ukrainian sovereignty and territorial integrity. The sanctions were crafted by an informal coalition of states politically and economically representing the West. Despite the Western nature of the sanctions, Russian and non-Russian companies (including Chinese) involved in Western markets tacitly respected the sanctions as well.

The sanctions against Russia comprise four areas: individual, political-diplomatic, sectoral and Crimea-related. The prohibitive measures signal Western displeasure with Russia's policy towards Ukraine, augment domestic constraints on the increasingly personalist political regime in Moscow, aim to gradually exhaust the sources of Russia's power that sustain its aggression against Ukraine, and significantly escalate the economic costs of Crimea's absorption into the Russian Federation. Ultimately, the goal of the sanctions is to help Ukrainian statehood survive amidst Russia's military aggression.

Although the sanctions were designed to have a cumulative effect in the mid to long term, they still have taken a heavy toll on Russia in the short term. Moscow's reactions to them often accentuated the impact of the sanctions. On the individual level, blacklisted politicians and business people in Russia sustained material and reputational costs; they experienced difficulties participating in global political and economic circuits or were denied enjoyment of their Western-held assets. On the political-diplomatic level, the sanctions brought Russia's efforts to join international organisations to a standstill (e.g., the OECD) and stymied any attempt to deepen relations with the West. This in turn reduced Russia's room to manoeuvre on the international scene and pushed Russia to re-engage with China from a position of weakness.

Sectoral sanctions exacerbated Russia's structural economic problems. These, together with a sharp decline in oil prices and its embargo against Western food products, sent the Russian economy into recession (dropping by 3.6% in the first half of 2015). In addition, the sectoral restrictions shelved Russia's ambitious

deep water, shale, Arctic oil and LNG projects. The sanctions also moderately slowed Russia's current rearmament programme, scheduled to last till 2020.

The Crimea-related sanctions fortified the "non-recognition policy" regarding the illegal annexation of Crimea and required additional funds from Russia to subsidise the peninsula's economy. While Ukraine previously had covered 63% of Crimea's budget, Russia has come to provide nearly 80% of the peninsula's financial needs. However, the money allocated for Crimean development often fell prey to rampant corruption, undermining the effectiveness of the state's investments. Abuse of power and widespread corruption have fomented occasional outbursts of popular discontent in Crimea.

As part of Russia's adaptation to the sanctions regime, the country's governing elites embarked on both an open and covert campaign to undermine the effectiveness of the sanctions, prevent new restrictions by the West, and remove ones already in place. Russian companies launched legal actions and politicians resorted to seeking exemptions from travel bans (e.g., by visiting headquarters of international organisations) to visit the West. Russia courted far-right and mainstream parties in Europe to challenge the "non-recognition policy" on Crimea and attempt to remove the sanctions. Business people close to the Kremlin were rewarded with lavish contracts with the state and aid from Russia's sovereign wealth funds. They also exploited legal loopholes to evade sanctions.

To maintain public peace when the populace was seeing lower incomes (down by 2.9% in the first half of 2015), the political regime relied on (open or hidden) censorship and manipulation of information on a massive scale. Absorbed by the developments in Ukraine, extensively covered by their mass media and propaganda, Russian citizens spent more time in front of the TV than before (up 2.5% from 2013). Misinformation of this magnitude fortified President Vladimir Putin's position domestically. However, the worsening economic situation and the public's ebbing interest in Ukraine later put the Kremlin's propaganda firewall under increasing pressure.

To support the economy and its defence projects, Russia pushed for import substitution programmes, which face an uncertain investment climate, a shortage of qualified workforce, a lack of private investment capital and know-how. To support import substitution and recapitalise its ailing banking sector, Russia unsealed its sovereign wealth funds (\$174 billion had been accumulated before the annexation of Crimea), a move that depleted a total of \$20 billion in a year's time. In foreign policy, Russia tried to bulldoze its way back from relative isolation through provocative military stunts, divide-and-rule tactics with the EU, intensification of its Middle Eastern policy and an economic pivot towards Asia. Although Russia has mounted serious challenges, Western unity on the sanctions has endured so far. At the same time, Russia has failed to replace the West with China as its main source of capital. For the last two years, Chinese investment in Russia has held constant. Then, in the first half of 2015, China's investments in Russia surprisingly decreased by 25%.

As the West ruled out "lethal protection" of Ukraine, the sanctions came to represent an efficient, low-cost tool to shelter Ukraine and constrain Russia's power. It was pivotal that the West responded as it did in 2014. Had it delayed, the Russian aggression, unopposed, would have threatened not only Ukraine's existence but some of its neighbours as well. In this case, the West would have been forced to design a response anyway, although one ultimately riskier and costlier.

The sanctions do not seek to weaken Russia per se. Their reversibility proves that the objective is to uphold Ukraine's sovereignty, not to take down the Russian state. While the sanctions are reversible, it is important to note the conditions under which they are softened or removed. It is fundamental to adhere to criteria for such actions, namely the implementation of the Minsk accords (for sectoral sanctions). Were the West to relax the sanctions before the criteria are fully met, the power-driven ruling elite in Russia would almost certainly interpret it as a sign of weakness, increasing the likelihood of a re-escalation of the conflict in Ukraine. Thus, instead of downsizing the costs of conflict management, premature elimination of the sanctions risks needing to increase them sharply.

Furthermore, by respecting the criteria for lifting (partially or fully) the sanctions, the West should be ready to introduce new sanctions as necessitated by the situation in Ukraine (e.g., a renewed offensive). This should undercut Russia's time advantage to escalate then rapidly de-escalate military actions to prevent further sanctions.

The sanctions will remain an important element of Western strategy towards Russia. However, sanctions are not a universal answer and should be supported by other tools. In addition to restrictive measures on Russia, the West should also commit to substantial and long-term assistance to modernise the Ukrainian economy and reform its security sector. Other members of the Eastern Partnership under economic and military pressure deserve additional EU focus, too. Commitments to strengthen the security of NATO's member states (from the decisions of the NATO Summit in Wales), particularly those neighbouring Russia, should be carried out, and, as the situation evolves, new sets of actions will be needed.

As this report suggests, a creative approach to reach out to the Russian population, which is misinformed about the West and kept in the dark about the country's domestic problems, should be part of Western strategy on Russia. Certainly, the door for engagement with Russia should remain open, too. But, this engagement should be a principled one so that the threshold for spheres-of-influence deals is hermetically closed.

# STRESZCZENIE

Od półtora roku Rosja boryka się z sankcjami nałożonymi w odpowiedzi na naruszanie przez nią suwerenności i integralności terytorialnej Ukrainy. Sankcje te zostały uzgodnione przez nieformalną koalicję państw, które reprezentują polityczne i gospodarcze interesy Zachodu, jednak milcząco zaakceptowały je firmy zarówno rosyjskie, jak i nierosyjskie (w tym chińskie), działające na zachodnich rynkach.

Sankcje nałożone na Rosję dzielą się na cztery kategorie: indywidualne, polityczno-dyplomatyczne, sektorowe i związane z Krymem. Mają one na celu zasygnalizowanie niezadowolenia z rosyjskiej polityki wobec Ukrainy, ograniczenie możliwości działania coraz bardziej spersonalizowanej władzy na Kremlu, doprowadzenie do wyczerpania źródła rosyjskiej siły umożliwiającej kontynuację agresji na Ukrainę i znaczące podwyższenie kosztów gospodarczych związanych z aneksją Krymu. Ostatecznym celem sankcji jest umożliwienie Ukrainie przetrwania wojskowej agresji ze strony Rosji.

Mimo że w zamierzeniu skumulowane efekty sankcji miały być widoczne po dłuższym czasie, już po kilku miesiącach ich obowiązywania okazało się, że mocno uderzyły w rosyjską gospodarkę. Co więcej, decyzje podejmowane w Moskwie często potęgowały ich skutki. Na poziomie indywidualnym Rosjanie, którzy znaleźli się na czarnej liście, ponieśli straty materialne i wizerunkowe – utrudniono im uczestniczenie w globalnych kręgach gospodarczych i politycznych, jak również korzystanie z majątku ulokowanego na Zachodzie. Na poziomie polityczno-dyplomatycznym sankcje powstrzymały rosyjskie starania o członkostwo w organizacjach międzynarodowych (m.in. w OECD) i o pogłębienie relacji z Zachodem. W efekcie ograniczyło to możliwości działania Rosji na arenie międzynarodowej i zmusiło ją do zwróceniu się ku Chinom z pozycji słabszego partnera.

Sankcje sektorowe pogłębiły strukturalne problemy rosyjskiej gospodarki. Wraz z gwałtownym spadkiem cen ropy i rosyjskim embargiem na zachodnie artykuły spożywcze wywołały w Rosji recesję (spadek PKB o 3,6% w pierwszej połowie 2015 r.). Ponadto pohamowały rosyjskie ambicje w przemyśle naftowym, w tym projekty *offshore*, w regionie Arktyki, plany związane z pozyskiwaniem ropy z łupków oraz projekty w dziedzinie LNG. Spowodowały również spowolnienie rosyjskiego programu modernizacji armii, który ma się zakończyć w 2020 r.

Sankcje związane z aneksją Krymu umocniły politykę nieuznawania nielegalnych działań Rosji w tym zakresie i zmusiły Kreml do przeznaczenia dodatkowych funduszy na finansowanie funkcjonowania półwyspu. Podczas gdy Ukraina pokrywała 63% budżetu Krymu, Rosja finansuje 80% jego potrzeb. Jednak pieniądze wydawane na rozwój półwyspu są często trwonione z uwagi na wszechobecną korupcję, która, wraz z nadużyciami władzy, powoduje sporadyczne wybuchy publicznego niezadowolenia na Krymie.

Próbując dostosować się do nowej sytuacji, Rosja rozpoczęła zarówno jawną, jak i niejawną kampanię w celu zmniejszenia skuteczności sankcji, nie tylko zapobiegającą nakładaniu nowych restrykcji, ale też łagodzącą już istniejące. Rosyjskie firmy podjęły działania prawne, zaś politycy starali się wykorzystać różnorodne sposoby obejścia zakazu podróży, jak np. wizyty lekarskie czy spotkania w organizacjach międzynarodowych. Rosja chciała uzyskać wsparcie europejskich partii, zarówno skrajnie prawicowych, jak i należących do głównego nurtu, aby zakwestionować politykę nieuznawania aneksji Krymu i znieść sankcje. Środowiska biznesowe blisko związane z Kremlen zostały nagrodzone hojnymi kontraktami publicznymi i pomocą finansową z rosyjskich funduszy inwestycyjnych. Środowiska te wykorzystują również luki prawne, aby omijać sankcje.

Aby utrzymać spokój społeczny wobec spadających dochodów obywateli (-2,9% w pierwszej połowie 2015 r.), władze oparły się na (jawnej i niejawniej) cenzurze oraz manipulacji informacjami na szeroką skalę. Pochłonięci rozwojem wydarzeń na Ukrainie, szeroko relacjonowanym przez media, Rosjanie spędzali więcej czasu przed telewizorami (w 2014 r. wzrost wyniósł 2,5% w porównaniu

z 2013 r.). Dezinformacja umocniła pozycję prezydenta Władimira Putina. Jednak pogorsząca się sytuacja gospodarcza i spadek zainteresowania Ukrainą wśród obywateli Rosji zwiększają presję na kremlowską machinę propagandową.

W kwestiach gospodarczych i militarnych Rosja zdecydowała się na programy substytucji importu. Ich realizację utrudniają niepewny klimat inwestycyjny, niedobór wykwalifikowanych kadr, deficyt prywatnych inwestycji i brak nowoczesnych technologii. Aby wesprzeć te projekty oraz dokapitalizować sektor bankowy, Rosja użyła państwowych funduszy inwestycyjnych, co w ciągu roku uszczupliło je o 20 mld dol. W domenie polityki zagranicznej Rosja starała się wyrwać z izolacji poprzez prowokacje militarne, wcielanie w życie zasady „dziel i rządź” w relacjach z UE, zwiększenie swojego zaangażowania na Bliskim Wschodzie oraz intensyfikację relacji gospodarczych z Azją. Pomimo tych działań solidarność Zachodu w stosowaniu sankcji została jak dotąd utrzymana. Jednocześnie Rosji nie udało się zastąpić Zachodu – jako głównego źródła napływu kapitału – Chinami. Po dwóch latach stagnacji chińskich inwestycji w Rosji w pierwszej połowie 2015 r. spadły one o 25%.

Biorąc pod uwagę, że Zachód wykluczył użycie bezpośrednich środków militarnych w celu obrony Ukrainy, sankcje sprawdziły się jako tanie i w miarę skuteczne narzędzie zmniejszania siły Rosji. Gdyby państwa zachodnie nie zareagowały w 2014 r., to najprawdopodobniej w 2015 r. musiałyby podjąć o wiele kosztowniejsze i bardziej ryzykowne działania, by zahamować rosyjską agresję, która do tego czasu mogłaby zagrażać również sąsiadom Ukrainy.

Celem sankcji nie jest osłabienie Rosji, lecz utrzymanie suwerenności Ukrainy. Istotną kwestią są warunki, na których sankcje mogą zostać złagodzone lub zdjęte. Ważne jest, aby trzymać się ustalonych kryteriów takich działań, tzn. realizacji porozumień mińskich (dotyczy sankcji sektorowych). Zachód nie powinien łagodzić sankcji, dopóki nie zostaną spełnione wszystkie warunki tego porozumienia, w przeciwnym razie rosyjskie elity władzy uznają to za oznakę słabości, co zwiększy prawdopodobieństwo eskalacji konfliktu na Ukrainie. Tym samym zbyt wczesne zniesienie sankcji, zamiast obniżyć koszty konfliktu, wiąże się z ryzykiem ich gwałtownego wzrostu.

Oprócz konsekwentnego stosowania kryteriów ewentualnego łagodzenia sankcji, Zachód powinien być gotowy na wprowadzenie nowych obostrzeń, jeżeli sytuacja na Ukrainie będzie tego wymagała (np. w razie przeprowadzenia nielegalnych wyborów w Donbasie lub nowej ofensywy separatystów). Taka postawa ograniczy rosyjskie możliwości eskalacji, a następnie raptownej deeskalacji akcji militarnych w celu uniknięcia kolejnych sankcji.

Sankcje pozostaną ważnym elementem strategii Zachodu wobec Rosji. Nie są one jednak uniwersalnym antidotum i powinny być wsparte wykorzystaniem innych instrumentów. Ponadto restrykcyjne działania wobec Rosji muszą iść w parze z długoterminowym wsparciem modernizacji gospodarki i reformy sektora obronnego na Ukrainie. Pozostali członkowie Partnerstwa Wschodniego, którzy również znajdują się pod presją gospodarczą i militarną ze strony Rosji, zasługują na wzmożoną uwagę ze strony UE. Podjęte w Walii przez NATO zobowiązania dotyczące wzmocnienia bezpieczeństwa graniczących z Rosją państw Sojuszu powinny być egzekwowane, a jeżeli sytuacja będzie tego wymagała, należy podjąć w tym zakresie nowe działania.

Częścią strategii Zachodu wobec Rosji powinny być próby dotarcia do rosyjskiego społeczeństwa, które jest wprowadzane w błąd nie tylko co do działań państw zachodnich, ale również sytuacji wewnętrznej w kraju. Równocześnie Zachód powinien podkreślać swoją gotowość do zbliżenia z Rosją. Jednak musi być jasne, że ewentualny dialog nie będzie możliwy, jeśli Rosja nadal będzie usiłowała budować swoje strefy wpływów.

# TOO MUCH OR TOO LITTLE?

Russia has been under a West-imposed sanctions regime for one and half years. Russia is a peculiar case and is unlike many states that have been penalised over the last two decades. It is a regional power that is militarily and economically more resourced than any other post-Soviet state. Russia's foreign policy ambitions extend far beyond its "near abroad" to southeast Europe, the Arctic, the Middle East and Asia-Pacific, where it can play both spoiler or contributor to regional order. Russia is an important supplier of hydrocarbons in the world and represents a sizeable consumer market. Russia is also a nuclear superpower and permanent member of the UN Security Council, which endows it with a veto (currently protecting Russia from UN-imposed sanctions) and a global role in ensuring the non-proliferation regime. Therefore, compared to Somalia, Haiti, Syria, North Korea or even Iran, Russia is an unusual target for sanctions in the post-Cold War order.

Previously, companies or low-ranking officials from Russia were blacklisted by the U.S. government for human rights abuses (for example, the so-called "Magnitsky Act"<sup>1</sup>) or the transfer of weapons and military technologies to Iran or Syria. The EU also resorted to mild political-diplomatic restrictions against Russia in the aftermath of two wars in the North Caucasus (1994–1996 and 1999–2000).<sup>2</sup> However, the variety and scale of sanctions imposed on Russia in 2014, this time by an informal coalition of states, stands out from the mild individual restrictions enacted before against Russia. In an international system

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<sup>1</sup> For the text of the law, see: "Russia and Moldova Jackson-Vanik Repeal and Sergei Magnitsky Rule of Law Accountability Act of 2012, Public Law 112-208," [www.gpo.gov/fdsys/pkg/PLAW-112publ208/html/PLAW-112publ208.htm](http://www.gpo.gov/fdsys/pkg/PLAW-112publ208/html/PLAW-112publ208.htm). For the story behind the Magnitsky Act see: B. Browder, *Red Notice: A True Story of High Finance, Murder, and One Man's Fight for Justice*, Simon & Schuster, New York, 2015.

<sup>2</sup> For more, see: C. Portela, "Member States Resistance to EU Foreign Policy Sanctions," *European Foreign Affairs Review*, no. 20 "Special Issue," 2015, pp. 49–50.

where power is often a decisive factor that defines the substance of inter-state relations, mighty regional players with global clout are chastised less often for misbehaviour than sub-regional disturbers of order. For instance, despite being politically reprimanded by the U.S. and EU, Russia emerged largely unscathed after its military adventure in Georgia in 2008. Nevertheless, once in a while, the big guns are punished, too. Six years after the Georgian escapade, Russia's aggression against Ukraine triggered the most comprehensive sanctions against Russia in decades. The infrequency of such punishments against trans-regional powers makes the multidimensional sanctions regime against Russia an even more compelling case for study.

In response to the annexation of Crimea, from March 2014, the EU, U.S. and other major players applied the first wave of individual sanctions on Russian officials and companies. As the military conflict flared up in eastern Ukraine, Russia was hit with two rounds of sectoral sanctions, and the punitive measures on Crimea were introduced. In 2015, individual and sectoral restrictions were extended to 2016, while members of the G7 agreed to do preparatory work on another set of penalties in case Russia escalated the hostilities in Ukraine. But the path towards the escalation or extension of sanctions has not been smooth, as their rationale and utility has been and continues to be constantly questioned, particularly in Europe.

Two camps, divided conventionally along the axis of "too much" and "too little," have criticised the sanctions. One group decries the sanctions as too harsh, warning that they could bring the Russian economy and political regime to collapse. Adherents of this argument conclude that the sanctions will add more problems than they will solve. Another strand of thought argues that the sanctions are too weak against such a powerful actor. Like a bumblebee before a bull, the sanctions sting rather than bite Russia, irritating it and making it more belligerent. This group also complains that the sanctions hinder cooperation in other regions, whereas Russia's counter-measures impose additional costs on the EU at a time when its economy is already limping. In spite of these contradictory views, both camps are in unanimity that the sanctions are unlikely to offer a way

out of the crisis. Instead, these groups suggest alternatives, such as lessening or removal of the sanctions, diplomatic engagement or camouflaged versions of a new grand bargain with Russia over Ukraine's head. The arguments of both camps are based on flawed logic, overlook factual data and misunderstand the design of the sanctions. As a result, there is often a distorted view about the sanctions and their value.

The "too much" camp ignores, for example, that the origin of Russia's economic troubles is its resource-based model, characterised by monopolisation, rent distribution and entrenched corruption—all in all serving as glue for the political regime. Removal of the sanctions will not make Russia's structural economic problems vanish. The too much camp also fails to notice that Russia's economy was cooling down before the introduction of the sanctions. Hence, the sanctions exacerbate rather than create economic troubles. Furthermore, the sanctions are designed to produce a moderate impact in the short run, gain force then multiply damage in the mid to long term. In this way, the sanctions give Russia the chance to either step back or face more painful consequences. Last but not least, this camp disregards the financial resources amassed by Russia during the last decade, which can be used to minimise the effect of the sanctions for a certain period of time. In the meantime, the Kremlin is likely to use the sanctions to coagulate the public around the authorities and tighten its grip on power. For the reasons above, apocalyptic predictions about Russia's near-collapse in the short term exclusively because of the sanctions are misleading.

Conversely, the "too little" camp tends to underestimate the short-term damage the sanctions cause Russia; even if moderate, the damages are far from negligible. At the same time, the too little camp overinflates the effects of Russia's counter-measures, which, according to data available so far (see examples below), the EU Member States have weathered well. Critics in this camp also ignore that the sanctions were one of the factors preventing Russia's further military expansion in eastern Ukraine in 2014. Without the sanctions, Ukraine's *de facto* border in the east would probably be very different from the current one, even more drastically reshaping the military-strategic environment in Central Europe

(e.g., Romania, Poland, Slovakia and Hungary). They further overlook the broader effect of the sanctions, namely to slowly suffocate the sources of Russian power that emboldened the Kremlin to act assertively against Ukraine. It is true that the sanctions cannot be a substitute for a solution; however, the sanctions create the space in which a peaceful resolution becomes more likely.

Scaling down or removing the sanctions through a grand bargain with Russia but done over Kyiv's head—suggestions proffered by both camps—invites more trouble, not only for Ukraine but also for Europe's entire vision of the post-Cold War order, reviving the "spheres of influence" logic that previously led to lose-lose outcomes on a global scale.

While the conflict in Donbass has subsided and a review of the sanctions is imminent (the EU's sectoral sanctions are set to expire on 31 January 2016), the larger debate about the utility of the sanctions is likely to be rejuvenated. Nevertheless, in the absence of a comprehensive assessment based on critical analysis of data available so far, the review risks being misguided by skewed and unsubstantiated opinions. This report aims to fill the void<sup>3</sup> and answer questions about the magnitude of the damage caused by the sanctions and address how Russia has adapted to the sanctions regime. First, it will briefly explain how the sanctions were designed, the rationales behind the individual and sectoral targets, and the anticipated effects. Second, the report will conduct a detailed damage assessment. Third, because Russia was not a passive target, the report will examine various ways in which it has acclimatised to the sanctions, ranging from avoidance to counter-measures, compensatory allocations and political technologies. The last part will draw conclusions about the effects of the sanctions and will propose to a list of lessons learnt and improvements to be implemented.

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<sup>3</sup> Two reports have been published recently on the sanctions' impact on Russia and which contribute to an informed debate on the utility of sanctions. This report intends to deepen the analysis and to add more dimensions to the study of the effects of the sanctions against Russia so far. For these reports, see: S. Oxenstierna, P. Olsson, "The Economic Sanctions against Russia—Impact and Prospect of Success," FOI, September 2015, [www.foi.se/sv/Sok/Sammanfattningssida/?rNo=FOI-R--4097--SE](http://www.foi.se/sv/Sok/Sammanfattningssida/?rNo=FOI-R--4097--SE); I. Dreyer, J. Luengo-Cabrera (eds.), "On Target? EU Sanctions as Security Policy Tools," EUISS Report No. 25, September 2015, [www.iss.europa.eu/uploads/media/Report\\_25\\_EU\\_Sanctions.pdf](http://www.iss.europa.eu/uploads/media/Report_25_EU_Sanctions.pdf).

# CRAFTING THE SANCTIONS

As one of the stakeholders of the European order, Russia embarked brazenly on a path of revisionism by annexing Crimea and waging war in eastern Ukraine. This triggered Western efforts to find the most effective way to penalise Russia for the violent change of borders and stonewall it. Russia's permanent seat on the UN Security Council precluded the possibility to enforce a multilateral sanctions regime. Moreover, China, another permanent member, would have certainly eschewed diplomatically from siding with the pro-sanctions camp in the UN Security Council. Moscow would wield its influence to dissuade several non-permanent members from supporting sanctions against Russia in order to avoid isolation on the Security Council. Any initiative would have quickly unravelled. Therefore, in the absence of institutionalisation of sanctions on Russia through the UN Security Council, the constant preoccupation of the U.S. and EU, the two driving forces behind the sanctions, was how to remain united on the issue and assemble a wide coalition of sanctions-supporting states. As one U.S. diplomat explained: "it is better to do less, but together."<sup>4</sup>

The reasoning behind this is that as more states enforce the sanctions, the higher the costs become and opportunities for evasion are reduced.<sup>5</sup> In addition to sharpening economic coercion, a robust group of sanctioning states gives autonomous sanctions the flavour of multilateralism. In the months following the annexation of Crimea, the U.S. and EU managed to coordinate each new set of sanctions and enrol, with various degrees of support, Canada, Japan, Australia, New Zealand, Norway, Switzerland, Iceland, Liechtenstein, Albania,

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<sup>4</sup> Author's interview with a U.S. diplomat, 2015.

<sup>5</sup> For debate and critique on the correlation between cooperation and sanction success, see: D.W. Drezner, "Bargaining, Enforcement, and Multilateral Sanctions: When Is Cooperation Counterproductive?," *International Organization*, vol. 54, no. 1, 2000, pp. 73–102.

and Montenegro. Looking at the list of states adhering to the sanctions regime against Russia, they economically and politically epitomise the West, or states on the path of Western integration. Despite criticism that the West often fails to act together, on the issue of sanctions against Russia, it performed as a coherent community of interests and values. But such behaviour was not pre-determined. Back in 2008, the West failed to mount substantial punitive measures against Russia after its military incursions into Georgia, sidestepping a short chill by pushing the “reset button.”<sup>6</sup> Despite differences (context, causes, ways of operating, and breadth of conflict) between the Georgian and Ukrainian cases, the introduction and endurance of a comprehensive sanctions regime against a state that previously has been a source of division in the West should be regarded as a remarkable achievement.

The sanctions as applied by parts of the Western coalition are not identical. The individuals and companies blacklisted by each state as well as the caveats under which sectoral sanctions apply may differ.<sup>7</sup> Nevertheless, in general, the sanctions follow the same logic and pull from a joint menu while targeting similar sectors. Generally, the Western sanctions on Russia are related to its violation of Ukraine’s sovereignty and territorial integrity and can be divided into four groups: sanctions against individuals or legal persons, political-diplomatic sanctions, sectoral sanctions and restrictions against Crimea.

The first category of sanctions encompasses a wide array of Russian civil servants, members of parliament, military or intelligence officers, journalists, and private individuals, including those who accumulated wealth thanks to their close relationship with Putin. As it is fashionable for Russia’s political and business

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<sup>6</sup> For the difference in the U.S. response to Russia’s aggression in Georgia and Ukraine, see: K. Stoner, M. McFaul, “Who Lost Russia (This Time)? Vladimir Putin,” *Washington Quarterly*, vol. 38, no. 2, 2015, pp. 167–187.

<sup>7</sup> For the differences and commonalities of sanctions applied by the West on Russia and a detailed list of targets, see: J. Ćwiek-Karpowicz, S. Secieru (eds.), *Sanctions and Russia*, PISM, Warsaw, 2015.

elite to keep money, own real estate, or send their children to study in the West,<sup>8</sup> the individual sanctions seek to deprive the blacklisted people from traveling to the West or using their assets there. In parallel, the individual restrictions freeze assets or bar certain Russian companies closely associated with the Kremlin from business opportunities in the West. The aim of the individual sanctions is to stop free-riding, which is manifested through active support, frequently accompanied by indirect profits, of the continuous violation of Ukraine's sovereignty and unrestricted access to benefits in the West. Besides irreparably tarnishing the reputation of those listed, the individual sanctions also downgrade the status of the targeted persons, who then cannot be fully part of the global political, business or sport circuits. Last but not least, weak internal constraining factors often encourage authoritarian leaders to pursue more aggressive policies abroad.<sup>9</sup> Thus, by sanctioning governing elites, punitive measures attempt to induce domestic constraints on an authoritarian regime with an increasing personalist touch, which was captured well by the deputy chief of the Russian presidential administration, Vyacheslav Volodin, in his syntagma, "no Putin, no Russia."<sup>10</sup>

The second type of sanctions comprise political-diplomatic actions that are unlikely to produce immediate, palpable effects on Russia, but at the same time will signal discontent with its policy, curtail cooperation and prevent any deepening of political or economic cooperation. Such measures envision reducing the intensity of high-level meetings (except those directly addressing a peaceful end to the conflict in Ukraine), suspension of negotiations on

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<sup>8</sup> For more, see: V. Sunkina, A. Patushin, E. Myazina, "Rassledovaniye RBK: V kakikh stranakh u rossiyskikh chinovnikov est nedvizhimost," *RBK*, 21 July 2014, <http://top.rbc.ru/economics/21/07/2014/937734.shtml>; E. Kalashnikova, "Gde zhivut deti vedushchikh rossiyskikh politikov," *812'Online*, 14 May 2014, [www.online812.ru/2014/05/14/007](http://www.online812.ru/2014/05/14/007).

<sup>9</sup> For the link between domestic constraints that stem from the existence of a strong domestic audience and authoritarian regimes' propensity to wage war, see: J.L.P. Weeks, *Dictators at War and Peace*, Cornell University Press, Ithaca-London, 2014.

<sup>10</sup> See: "No Putin, No Russia; Says Kremlin Deputy Chief of Staff," *The Moscow Times*, 23 October 2014, [www.themoscowtimes.com/news/article/no-putin-no-russia-says-kremlin-deputy-chief-of-staff/509981.html](http://www.themoscowtimes.com/news/article/no-putin-no-russia-says-kremlin-deputy-chief-of-staff/509981.html).

general or sectoral agreements, enforcement of limitations in connection with participation in regional inter-governmental organisations or informal global forums. Since the early 1990s, Russia, out of prestige but also practical utility, was busy integrating into international structures and expanding bilateral economic ties with the West. The purpose of the political-diplomatic sanctions is to stave off this drive temporarily and signal that if Russia continues its current policy in Ukraine it risks becoming a global outcast.

The Western sectoral sanctions work in three fields: finance, defence and energy. These sectors were not selected randomly. According to Russia's Central Bank (RCB), the country's external debt (public and private) ballooned from about \$151 billion in December 2002 to a record high—\$732 billion—in June 2014. The main chunk of debt (almost \$660 billion) is represented by corporate and quasi-corporate (state companies) obligations, which swelled on massive borrowing from the West. Hence, in the financial field, Russia is interconnected with the West, leaving it vulnerable should access to loans and credits be instantly denied. The financial sanctions are asymmetric, as Western banks' exposure to Russia in most cases is not critical.<sup>11</sup> Even in instances when banks hold substantial portfolios in Russia, banks were consulted and worked closely with governments to design sanctions to reduce risks stemming from the sanctions to a minimum.<sup>12</sup> Among the top oil exporters in the world, Russia derives significant revenue from this field (\$283 billion in 2013, which represents 54% of total export revenues). Hence, sanctions in the energy sector target significant sources of cash for Russia. Western states import few weapons from Russia. Instead, "we have been surprised how much Russia relies on defence imports for its arms modernization program," explained one Western diplomat on the decision to enact sanctions on the military-industrial sector of Russia.<sup>13</sup>

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<sup>11</sup> For data on the exposure of Western banks to Russia, see: M. Thompson, "Western Banks Lend Billions to Russia," *CNN*, 20 March 2014, <http://money.cnn.com/2014/03/20/news/economy/russia-west-banks>.

<sup>12</sup> Author's interview with the top manager of a U.S. commercial bank, 2015.

<sup>13</sup> Author's interview with a Western diplomat, 2015.

Although potentially the most harmful group of sanctions, not all sectoral measures are conceived to inflict instantaneous and prohibitive costs on Russia.

Due to the high levels of corporate debt, restrictions on access to Western capital markets by major Russian state-owned banks and energy companies were intended to have a rapid effect. The suspension of new funding projects for Russia by the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD) complements sanctions in the financial sector. At the same time, prohibitions on arms exports, dual-use technologies for defence and equipment or services for certain oil exploration and production activities in Russia are designed to have a strong cumulative effect in the mid and long terms. As one U.S. official recognised, “we have no intention to provide Putin with a bonus by introducing an oil embargo and driving the oil price up.”<sup>14</sup> For this reason, instead of curtailing Russia’s oil exports overnight, the sanctions seek to prevent new deep water, arctic or shale oil projects that would affect oil production levels in the future. The sanctions also indirectly and directly will affect gas projects, in particular curtailing ambitions to increase Russia’s LNG exports. In the defence field, Russia is the world’s second-largest arms exporter, with a 27% share of the market in 2013. Still, according to top Russian officials, the defence industry relies on imports from NATO and EU Member States in 640 positions, mainly in optics and radio electronic components.<sup>15</sup> In reality, the figure could be much higher and likely covers more fields than stated officially. Similar to oil sanctions, prohibitions in the defence sector should have a gradual, delayed impact on Russia instead of an immediate shock, as the industry still has spare parts and components available from before the introduction of the sanctions. The sanctions, though, go beyond arms production, delaying modernisation of the Russian defence industry’s production platforms.

The fourth group of sanctions aims to enforce the “non-recognition policy” regarding the annexation of Crimea and hike the costs of peninsula absorption and

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<sup>14</sup> Author’s interview with a U.S. official, 2015.

<sup>15</sup> See: “Rogozin nazval stepen zavisimosti oboronki ot postavok s Zapada,” *Lenta*, 3 June 2015, <http://m.lenta.ru/news/2015/06/03/bestenemy>.

development by Russia. Therefore, the sanctions on Crimea follow the principled position against changes of state borders by force and pursues economic logic in order to increase the bill for such actions for the aggressor. In 2013, Ukraine subsidised 63% of Crimea's budget. Since March 2014, it has been Russia's financial burden. Furthermore, because water, electricity and transportation infrastructure links Crimea with continental Ukraine, substantial investments will be needed to connect the peninsula with Russia instead. With these factors in mind, the Western sanctions banish trade, investment and provision of services (e.g., brokering, engineering, construction, tourism) and technologies to the peninsula, in particular in the telecommunication, transportation and energy sectors. These restrictions have been reinforced by the European agency for air navigation safety, EUROCONTROL, which has suspended flights to Crimea, and a UN General Assembly resolution (from 27 March 2014), which among other things calls for its specialised agencies (e.g., the International Maritime Organisation) and their member states to abstain from any actions that could be interpreted as recognition of Crimea's status change. Sanctions also restrict the issuance of visas for inhabitants of Crimea holding Russian passports. This set of penalties will likely be in effect much longer than the other categories of punitive measures, as Russia shows no sign of reversing its decision to annex Crimea and has rather strived to entrench its military presence on the peninsula.

# DAMAGE ASSESSMENT

## Grounding Effect

Far from having calamitous effects, the individual sanctions caused only moderate financial damage, disrupted some well-established business schemes and luxury projects, as well as hindered indirectly the activity of Russian state mass media outlets involved in disinformation campaigns overseas. Bank Rossiya and its subsidiary Sobinbank, controlled by Yuri Kovalchuk, a long-time friend of the Russian president, incurred losses in the U.S. as bank assets totalling \$572 million were frozen by the Treasury Department. Arkady and Boris Rotenberg (brothers who had been judo sparring partners of President Putin), who are the main shareholders of SMP Bank and InvestCapitalbank, for similar reasons could not access \$65 million in blocked U.S. accounts.<sup>16</sup> Besides the frozen accounts, Bank Rossiya, SMP bank and their subsidiaries faced difficulties with card operations. MasterCard and Visa ceased handling transactions with cards issued by these banks. To some degree, payments with cards in Russia were re-established thanks to internal agreements with Russian banks that were not blacklisted. However, in December 2014 Sobinbank stopped issuing new cards and then later, in January 2015, cancelled service for cards that were in circulation. At the same time, SMP bank encountered technical problems issuing new MasterCard or Visa cards or extending the validity period of those due to

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<sup>16</sup> P. Shishkin, "U.S. Sanctions over Ukraine Hit Two Russian Banks Hardest," *The Wall Street Journal*, 5 March 2015, [www.wsj.com/articles/u-s-sanctions-over-ukraine-hit-two-russian-banks-hardest-1425597150](http://www.wsj.com/articles/u-s-sanctions-over-ukraine-hit-two-russian-banks-hardest-1425597150).

expire.<sup>17</sup> As a collateral effect of the individual sanctions, other payment systems or money transfer services declined to cooperate with the sanctioned banks. For instance, Japanese service JCB and Chinese system UnionPay refused to issue cards for SMP Bank. At the same time, the leader in money transfers inside Russia, Golden Crown (46% share of market), interrupted its cooperation with Bank Rossiya, SMP Bank and their subsidiaries.

In Europe, one of the Rotenberg brothers (Arkady) sustained additional losses. Italy froze his bank accounts, shares and real estate worth almost \$40 million. Sanctions against the other brother (Boris) cast a shadow over sponsorship of his project, SMP Racing team, which participates in prestigious international car racing competitions (e.g., 24 Hours of Le Mans). Another old friend of the president on the U.S. sanctions list, Gennady Timchenko (also a shareholder in Bank Rossiya), struggled to raise more than \$10 billion in the West required for the implementation by Novatek (of which he is also shareholder) of the expensive Yamal LNG project. The sanctions also grounded his luxurious G650 jet, as U.S.-based Gulfstream apparently declined to provide maintenance service for the aircraft.<sup>18</sup> Prohibited from entering U.S., Timchenko opted to stay away from Europe, too, moving his permanent residence from a luxurious home in Switzerland to Moscow.

Other individuals or legal persons, not as close to the president's inner circle, found themselves in troubles as well. Dmitri Kiselyov, who heads the RT (formerly, Russia Today) network, is among the most vocal supporters of President Putin on Russian television. After he was barred from travelling to the EU, he vowed to spend his vacations in Russia instead. Because of his managerial status at RT, the account (at Barclays bank) of the Russian-state news agency in the UK was blocked. In addition, for similar reasons, BBVA bank refused to transfer to RT's

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<sup>17</sup> "Sanktsionnyye banki ne smogli zakazat plastik dlya kart Visa i MasterCard," *RBK*, 21 April 2015, <http://top.rbc.ru/finances/21/04/2015/5536147f9a79473b3fdec816>.

<sup>18</sup> See: "Businessman Timchenko's Luxury Jet 'Grounded by U.S. Sanctions,'" *The Moscow Times*, 3 August 2014, [www.themoscowtimes.com/business/article/businessman-timchenko-s-luxury-jet-grounded-by-u-s-sanctions/504469.html](http://www.themoscowtimes.com/business/article/businessman-timchenko-s-luxury-jet-grounded-by-u-s-sanctions/504469.html).

account profits the channel had gained from advertising. One of the wealthiest representatives of Russia's Federation Council and an active supporter of the annexation of Crimea, Andrey Klishas, after being sanctioned lost access to a lavish villa in Switzerland, which he had declared in a revenue statement.

In addition to the financial distress, the individual sanctions complicated or prevented state dignitaries from representing Russia abroad on several occasions. The scheduled visit of the speaker of Russia's lower house of parliament, Sergey Naryshkin, saw his trip to Sofia in May 2014 cancelled by Bulgarian authorities who were adhering to the EU individual sanctions list on which the Russian official had been placed. In a face-saving attempt, the Russian side communicated that the visit was cancelled by "mutual agreement."<sup>19</sup> The same month, Russian Deputy Prime Minister Dmitri Rogozin, also on the EU travel ban list, was involved in an incident connected to his representation of Russia abroad. His plane transited Bulgarian and Romanian airspace on the way to Moldova, made possible by misinformation given to traffic controllers regarding the names of the passengers on board.<sup>20</sup> Once he landed in Chisinau it became obvious that the sanctions regime had been violated. Rogozin had to embark alone on a regular flight between Chisinau and Moscow as his plane was refused the right to transit via Romanian and Bulgarian air space. On his return to Moscow, the deputy prime minister promised that next time he would fly in a TU-160 strategic bomber. Despite his bellicose declarations, the frequency of his trips to Moldova (especially to the separatist region Transnistria) subsided visibly, with the problems generated by the individual sanctions partially responsible for this.

In 2015, Sergey Naryshkin could not make the OSCE Parliamentary Assembly in Helsinki. In retaliation, the entire Russian delegation refused to attend the

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<sup>19</sup> "Bulgaria Cancels Visit of Sanction Hit State Duma Speaker," *The Moscow Times*, 30 April 2014, [www.themoscowtimes.com/article/499219.html](http://www.themoscowtimes.com/article/499219.html).

<sup>20</sup> "Avionul în care se afla Rogozin a trecut în mod fraudulos prin spațiul aerian românesc," *PRO-TV*, 12 May 2014, <http://stirileprotv.ro/stiri/politic/corlanean-sprijin-la-bruxelles-in-urmanenintarilor-absolut-inacceptabile-ale-lui-rogozin-la-adresa-romaniei-si-moldovei.html>.

event. In August 2015, the speaker of the upper house of the Russian parliament, Valentina Matviyenko, who is blacklisted in the U.S., pretended to be a victim of the sanctions regime, too. Although she had been granted a U.S. visa to attend an Inter-Parliamentary Union session on the premises of the UN in New York, it contained time and space restrictions. Given those conditions, she declined to visit the U.S. and the entire Russian delegation decided to stay home.

### **No Longer a Strategic Partner (Even in Words)**

The political-diplomatic sanctions substantially downgraded the relations between the West and Russia and put on ice the latter's initiatives to foster deeper economic and security ties with the Western community of states. Even as an immediate neighbour who had built a complex web of interconnections with Russia, the EU adopted the longest list of measures. It put off its visa dialogue (which one day could result in visa-free travel) and iced a new accord with Russia to replace the existing Partnership and Cooperation Agreement. Bilateral summits with Russia organised twice per year were also cancelled. Thus, since January 2014 there have been no EU-Russia summits. The EU also addressed its Member States not to organise bilateral summits with Russia. Together with other members of the G8 (minus Russia), the EU was behind the decision to scrap preparations for the G8 summit in Sochi and instead held a G7 meeting in Brussels. Since 2014, the G8 has operated in the G7 format. The EU Member States also decided to back the suspension of negotiations on Russia's accession to the OECD and International Energy Agency.

The Parliamentary Assembly of the Council of Europe (PACE) upheld this approach. With an overwhelming majority, PACE in April 2014 suspended the "voting rights of the Russian delegation, its representation in the institution's leading bodies and right to participate in election observation missions."<sup>21</sup> These

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<sup>21</sup> See: "Citing Crimea, PACE suspends voting rights of Russian delegation and excludes it from leading bodies," 10 April 2014, <http://assembly.coe.int/nw/xml/News/News-View-EN.asp?newsid=4982&cat=8>.

measures were extended several times and should be in place until at least January 2016. This is an unprecedented long duration for restrictive measures on Russia, as the last time its voting rights were suspended in PACE was in April 2000 (during the second war in Chechnya), lasting until January 2001.

Across the pond and in the Pacific, more actions in this direction have been taken, too. The U.S. halted military cooperation and talks with Russia on an investment treaty. Following the U.S. lead, NATO suspended military and civilian cooperation with Russia. The Alliance still maintained communication within the NATO-Russia Council at the ambassadorial level and kept the direct phone line between top military staff. At the same time, NATO at the Newport Summit adopted a set of measures in order to safeguard its eastern flank. Japan put on hold negotiations on military affairs, space, trade and visa issues with Russia and delayed the Abe-Putin summit previously agreed.

The internationalisation of Russia's economic integration initiatives in the post-Soviet world also fell victim to the annexation of Crimea. Switzerland in March 2014 stopped negotiations on a Free Trade Area with the Customs Union of Russia-Belarus-Kazakhstan (CU RBK). The same decision was taken by New Zealand, whose authorities had finalised talks and were about to sign the deal in the first half of 2014.<sup>22</sup>

## Triple Punch

The sectoral sanctions produced immediate quantitative and psychological effects in the **financial field**. It hurt the overall Russian economy as well as scared off investors. The damage was made stronger as the sanctions were enacted at a time of feeble economic growth in Russia (1.3% in 2013) and a sharp decline in the oil price on the world market (50%). Although the precipitous drop in the oil price squeezed Russia's budget revenues (by an estimated \$160 billion), the

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<sup>22</sup> Author's interview with a New Zealand diplomat, 2014.

direct and collateral consequences of the financial sanctions on Russia's ailing economy should not be discarded.

For more than two decades, Russia had been the largest client of the EBRD. The bank supported 792 projects in Russia, totalling €24.3 billion (€18.3 billion disbursed as of December 2014). Almost 90% of the lending went into the private sector, with industry, trade, and the agricultural sector among the main beneficiaries (45%).<sup>23</sup> Due to the sanctions, though, the EBRD will not commit to new investments in Russia, depriving the country in the coming years of around €1 billion annually it could use to attract and support private sector development. Russia's engagement with the EIB is less intensive. Based on a framework agreement with Russia, in force since 2004, the EIB between 2009 and 2013 put aside €1.2 billion, with another €340 million waiting for approval in 2014. A big share of the EIB loans in Russia eyed energy, telecommunications and industry.<sup>24</sup> As a result of the sanctions, the EIB refrained from providing €600 million in loans in 2014 (as had been scheduled) and froze financing for other projects under which Russia would have received from €700 million to €1 billion annually, starting in 2015.<sup>25</sup> The number of loans blocked by EBRD and EIB might not be significant to a rising economy able to attract international private capital, but are felt acutely by a declining and less appealing economy. Actually, the EBRD's decision sends a discouraging signal for current and potential foreign investors in Russia.

Besides lost opportunities to finance projects from EBRD or EIB loans, Russia suffered immensely due to limited access to Western financial markets. Long-term loans from the West were important sources of capital investments and drove Russia's economic growth in previous years, but had now ceased. Under

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<sup>23</sup> "The EBRD in Russia," EBRD, [www.ebrd.com/where-we-are/russia/data.html](http://www.ebrd.com/where-we-are/russia/data.html).

<sup>24</sup> See: "Evropeiskiy Investitsionnyy Bank," Russian Central Bank, [www.cbr.ru/today/print.aspx?file=ms/smo/eib.htm&pid=smo&sid=ITM\\_33175](http://www.cbr.ru/today/print.aspx?file=ms/smo/eib.htm&pid=smo&sid=ITM_33175).

<sup>25</sup> See: A. Rinke, M. Martin, "EIB says will not provide planned loans to Russia due to EU sanctions," *Reuters*, 17 July 2014, [www.reuters.com/article/2014/07/17/us-ukraine-crisis-sanctions-eib-idUSKBN0FM2D520140717](http://www.reuters.com/article/2014/07/17/us-ukraine-crisis-sanctions-eib-idUSKBN0FM2D520140717).

the impact of the sanctions, capital investment in Russia dropped by 2.5% in 2014 and plunged by 5.9% in the first seven months of 2015.<sup>26</sup> In addition, Russian companies and banks have to make large repayments equal to 10% of GDP in the last quarter of 2014, 5% of GDP in 2015, and 3% of GDP in 2016. Thus, instead of concentrating resources on capital investments, they have to commit more funds for debt service.<sup>27</sup>

The financial sanctions will contribute to a reduction of Russia's external debt in the years to come. It already dwindled spectacularly in one year from \$732 billion to \$556 billion. But this comes with a heavy price tag in Russian currency reserves, the value of the rouble, and ultimately on the population's real income. Increased demand for foreign currency on the pick of payments schedule put supplementary pressure on the rouble and forced the RCB to pour foreign currency into the economy in order to saturate the market and calm the situation. From August 2014, when the first financial sanctions were introduced, till June 2015, Russia's international reserves shrank by \$107 billion.<sup>28</sup> On the other hand, in some cases, the RCB through murky schemes also indirectly provided Russian state companies with cash to meet their external obligations (e.g., Rosneft had to repay \$6.9 billion in December 2014), contributing to a devaluation of the rouble that culminated in another "black Tuesday" (16 December 2014), when it lost 20% of its value.

The rouble's decline accelerated inflation, which hit 11.4% at the end of 2014 and spiked to almost 17%, year-on-year, in March 2015, the highest in more than a decade. By depressing the purchasing power of citizens, it annihilated the other potential engine of Russian economic growth, namely

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<sup>26</sup> "V iule padenie investitsii v osnovnoy kapital v Rossii uskorilos do 8.5%," *Finmarket*, 19 August 2015, [www.finmarket.ru/news/4088362](http://www.finmarket.ru/news/4088362).

<sup>27</sup> S. Aleksashenko, "Ekonomicheskomu razvitiyu meshayet politicheskaya sistema," *Novaya Gazeta*, 7 July 2015, [www.novayagazeta.ru/economy/69117.html?utm\\_source=see\\_also&utm\\_medium=click&utm\\_content=relap&utm\\_campaign=relap\\_vs\\_nextclick](http://www.novayagazeta.ru/economy/69117.html?utm_source=see_also&utm_medium=click&utm_content=relap&utm_campaign=relap_vs_nextclick).

<sup>28</sup> Russia's international reserves dwindled due to RCB interventions, but also because of the decline in the price of gold and use of sovereign funds which are part of the reserves. See: "International reserves of Russian Federation—monthly values," Russian Central Bank, [www.cbr.ru/Eng/hd\\_base/?Prtid=mrrf\\_m](http://www.cbr.ru/Eng/hd_base/?Prtid=mrrf_m).

household consumption, which amounted to more than 50% of Russia's GDP in 2013. Among consumption-oriented sectors of the economy, retail sales play a crucial role, contributing up to 9% of GDP. According to the Russian statistical agency, in the first half of 2015, retail sales fell by 8.1%, a meltdown unseen since the 1998 financial crisis.<sup>29</sup> The sector is unlikely to bounce back soon because the government is forced to cut budget expenditures and therefore is not in a position to keep up the pace of indexation to inflation in pensions (affecting around 44 million pensioners) or salaries in the public sector or organisations affiliated with it (more than 30% of the workforce). Growing delays in salary payments, systemic problems through the 1990s, will also hold back private consumption. Since August 2014, wage arrears had spiked by 54%.<sup>30</sup> If the trend persists, it risks to undo one of the Kremlin's pillars of stability, namely a salary paid on time.

The financial sector sanctions also undermined foreign investor trust and increased the uncertainty over doing business in Russia. Consequently, many wound down investments or left Russia until better times. In 2015, Norway's sovereign wealth fund halved its participation in Russia's VTB bank. The UK's Royal Bank of Scotland (RBS) also intends in 2015 to sell off its assets in Russia totalling \$2.5 billion.<sup>31</sup> Deutsche Bank will follow in RBS's footsteps. The Templeton Russia and East European Fund (TREEF), after 20 years operating on the Russian market (with shares of Lukoil and Sberbank in its portfolio) announced its liquidation, mentioning the sanctions and growing risks as factors among the motives that influenced the decision.<sup>32</sup> The TREEF decision reflects a general trend. In 2014,

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<sup>29</sup> See Rosstat data: [www.gks.ru/wps/wcm/connect/rosstat\\_main/rosstat/ru/statistics/enterprise/retail/#](http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/enterprise/retail/#).

<sup>30</sup> O. Volkova, "V Rossii zafiksirovali rezkiy rost zadolzhennosti po zarabotnoy plate," *RBK*, 18 August 2015, <http://top.rbc.ru/economics/18/08/2015/55d371f99a79478eb8591dc3>.

<sup>31</sup> See: R. Partington, A. Choudhury, "RBS Said Close to Selling Russian Banking Assets to Local Buyer," *Bloomberg*, 18 August 2015, [www.bloomberg.com/news/articles/2015-08-18/rbs-said-close-to-selling-russian-banking-assets-to-local-buyer](http://www.bloomberg.com/news/articles/2015-08-18/rbs-said-close-to-selling-russian-banking-assets-to-local-buyer).

<sup>32</sup> "Legendarnyy amerikanskiy investor zakrivayet fond, vkladivavshiy v Rossiyu," *Newsru*, 20 July 2015, [www.newsru.com/finance/20jul2015/templton.html](http://www.newsru.com/finance/20jul2015/templton.html).

Russia recorded the highest net outflow of capital in its post-Soviet history. A massive \$154.1 billion run in 2014 represented a 250% increase in comparison to 2013. In the first six months of 2015, capital flight slowed pace to \$52.5 billion, a figure which is still high compared to previous years.

As capital was leaving Russia, its stock exchange took a big hit. The RTS index lost more than 50% in 2014, making the Russian stock market the worst performer in the world, even worse than Greece's or Nigeria's. By the end of 2014, Russian stock exchange capitalisation (\$517 billion) was below that of Apple Inc alone (\$647 billion). Russian companies followed the negative trend. In the FT 500 global ranking for 2015 there were five Russian companies, down from eight in 2013. But none made it into the world's top 100, unlike in 2013 when three companies reached it. At the same time, capitalisation of Russian companies in FT 500 plummeted from \$430 billion in 2013 to \$198 billion in 2015.<sup>33</sup> Gazprom recorded the most spectacular slump in market capitalisation, from \$101 billion in 2013 to \$51 billion in August 2015, making top management's ambitions to reach \$1 trillion in market value by 2017 unattainable. Rosneft CEO Igor Sechin admitted that the sanctions were among the causes behind the contraction of the company's capitalisation. The same is true for other Russian blue chip stocks. Observing the growing volatility and economic risks attached to it, international rating agencies (e.g., S&P and Moody's) slashed in 2015 Russia's sovereign rating to non-investment grade for the first time in a decade. Known as "junk" status, non-investment grade likely will keep away investors and lure more speculators to Russia.

Sanctions in the financial field have had direct repercussions on Russian (in particular on state) banks as well. Squeezed of liquidity and forced to build stronger reserves to weather the economic crisis, Russian bank profitability collapsed. The RCB's high interest rates, hiked to defend the rouble, also feed into poor profits in the banking sector. If in 2013 a banks' profits had declined by only

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<sup>33</sup> For more, see: "FT 500 Ranking in 2013," *Financial Times*, [www.ft.com/intl/indepth/ft500](http://www.ft.com/intl/indepth/ft500); "FT 500 Ranking in 2015," *Financial Times*, [www.ft.com/intl/cms/s/0/988051be-fdee-11e3-bd0e-00144feab7de.html](http://www.ft.com/intl/cms/s/0/988051be-fdee-11e3-bd0e-00144feab7de.html).

1.8%, by the end of 2014 they had dropped by nearly 41%. Russia's first, second and third largest lenders—Sberbank, VTB and Gazprombank, respectively—recorded declines in profits of 22%, 43% and 30%, respectively. Another state bank on the Western sanctions list, Rosselkhozbank, went into the red in 2014.<sup>34</sup> In the first seven months of 2015, Russian banks profits shrank by another 93% compared to the similar period in 2014.<sup>35</sup> For all of 2015, the RCB forecasts Russia's banking sector to earn \$2 billion, down from \$9 billion registered in the already problematic 2014. Nevertheless, data for the first half of 2015 show that the banking sector will perform below the RCB's expectations.

As anticipated, sanctions in the **energy field**, have not immediately reduced Russia's oil output. On the contrary, it grew (partially to offset the oil price decline) by a meagre 0.6% in 2014, and by 1.1% in the first half of 2015. It is anticipated that Russia's oil sector will be able to sustain its current levels of crude oil production to the end of the year. However, in 2016 the trend could reverse, with sanctions being one of the factors behind the probable slow decline in Russia's oil output. As production in current oil fields is set to decline from 470 million tonnes in 2015 to 417 million tonnes in 2020, Russia's Ministry of Energy plans under an optimistic scenario to compensate in part for the decline by extracting 62 million tonnes of hard-to-recover oil<sup>36</sup> (which includes shale oil) and from offshore oil production.<sup>37</sup> Nevertheless, the restrictive measures in the energy field likely will curtail Russian companies' long-term ambitions to increase the share of shale oil production or tap into Arctic or deep water oil and gas reserves.

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<sup>34</sup> N. Starostina, A. Koshkarov, "Tyazhelyy god: kakiye banki smogli poluchit pribyl v 2014 godu," *RBK*, 28 January 2015, <http://top.rbc.ru/finances/28/01/2015/54c79f2a9a7947bc19dc0bf6>.

<sup>35</sup> See: "Rossiskiye banki v iyule sokratili pribil do 34 mlrd rubley," *Kommersant*, 13 August 2015, <http://kommersant.ru/doc/2787823>.

<sup>36</sup> In Russia, "hard-to-recover reserves include shale resources, ... but also include bitumen, a very viscous crude that is extracted from shallower reservoirs using mining or steam techniques, as well as oil that comes from conventional reservoirs that happen to have low permeability and/or porosity." See: J. Henderson, *Tight Oil Developments in Russia*, WPM 52, The Oxford Institute for Energy Studies, October 2013, p. 4.

<sup>37</sup> "Importozameshchenie v neftegazovom komplekse Rossii," Ministerstvo Energetiki Rossiyskoy Federatsii, 2015, <http://oilandgasforum.ru/data/files/Files%200315/Novak.pdf>.

Several projects have been delayed or put on hold as foreign partners with the necessary expertise and sufficient technology withdrew, and as Western banks were reluctant to provide finances. In 2014, Royal Dutch Shell suspended cooperation with Gazprom Neft (a subsidiary of Gazprom) on a shale oil project in Siberia. In 2015, French oil giant Total announced its exit from a joint venture with Lukoil (which has been sanctioned as well) for exploration of oil on the Bazhenov formation. Both Lukoil and Gazprom Neft pledged to continue their respective projects alone. After drilling the first offshore well in the Kara Sea (part of the Arctic Ocean) in 2014, ExxonMobil, supported by Norwegian North Atlantic Drilling, had to interrupt further works in a project developed with Rosneft. Failing to find other partners in 2015, Rosneft had to postpone drilling of a second well until 2018 and freeze its logistic base expansion in Murmansk Oblast for arctic projects. The latter case reveals that Russia's logistic capacity to initiate and conduct such projects alone is very limited. Some 68% of all equipment imported by Russia's oil and gas industry is now inaccessible due to sanctions.<sup>38</sup> At the same time, for hard-to-recover oil projects Russian companies need to import 50% of the equipment and 80% of the software. Its dependency is even more profound in the case of offshore projects, where Russia relies on 80% of imported equipment and 90% of software.<sup>39</sup>

Russia's offshore projects that already produce oil are poised to suffer because it will be difficult to continue extraction in the long run without maintenance-related services and deliveries of spare parts for damaged equipment. For example, Gazprom Neft's offshore production of oil in the Pechora Sea relies on two Norwegian-built multifunctional icebreakers and uses an adapted ice-resistant platform for offshore drilling bought from a Norwegian company. Moreover, in order to keep up platform functions, Gazprom Neft relies significantly on foreign partners, too. Thus, the future of oil production in the Pechora Sea is in doubt. In

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<sup>38</sup> See: "Minenergo predlozilo vesti parallelnyy import burovogo oborudovaniya," *Vedomosti*, 17 July 2015, [www.vedomosti.ru/business/articles/2015/07/17/601012-udastsya-li-rossii-oboiti-zapret-na-vvoz-neftegazovogo-oborudovaniya-s-pomoschyu-paralelnogo-importa](http://www.vedomosti.ru/business/articles/2015/07/17/601012-udastsya-li-rossii-oboiti-zapret-na-vvoz-neftegazovogo-oborudovaniya-s-pomoschyu-paralelnogo-importa).

<sup>39</sup> "Importozameshchenie v neftegazovom komplekse Rossii," *op. cit.*

addition, should Gazprom Neft decide to explore new offshore fields, it likely will hit a wall without Western equipment and technology.

Besides the reduction in extraction of crude oil, the sanctions risk undermining Russia's refinery capacities. In 2015, out of 37 refineries, 15 postponed for 1–4 years their plans to modernise their plants. In addition to a weaker rouble, the companies face problems with importing foreign equipment necessary for the refineries' upgrades. Experts do not rule out that a delay in refinery modernisation might lead to a deficit of fuel in Russia in 2016.<sup>40</sup>

The financial sanctions, coupled with restrictions in the energy field, have changed Russian energy giants' plans for costly gas projects that had been massively funded through Western loans and implemented with imported technologies and equipment. Rosneft apparently had to move the deadline for construction of an LNG factory in Sakhalin from 2018 to beyond 2020. Gazprom failed to secure \$520 million in loans for development of a chemical gas complex in Novyurengoi. The Russian gas monopoly also seems to have ditched a new LNG factory project with a 5 million tonne capacity near Vladivostok. On stream LNG projects have encountered difficulties, too. Gazprom delayed an investment decision to expand the Sakhalin-2 LNG factory because some of the gas for a third line with a 5 million tonne capacity should come from the Yuzhno-Kirinskoye field in the Sea of Okhotsk but which has been under U.S. sanctions since August 2015. The required equipment for this project is produced only by the U.S. and Norway. Therefore, the 2018 deadline to begin gas production at Yuzhno-Kirinskoye, where so far only six wells have been drilled, looks increasingly unrealistic. Looking forward, the sanctions severely constrain Russian companies' aspirations to boost LNG production after 2020, keeping Russia locked into pipeline gas exports for the near future.

Besides direct measurable effects on the oil and gas sector, the sanctions could have an indirect impact on other sectors (e.g., nuclear) of Russia's energy industry. Spooked by Russia's modus operandi in Ukraine and the sectoral

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<sup>40</sup> L. Podobedova, "Bolshe treti krupnykh neftezavodov v Rossii sdvinuli sroki modernizatsii," *RBK*, 10 August 2015, <http://top.rbc.ru/business/10/08/2015/55c85b0d9a794723de8cc30c>.

sanctions, potential clients are likely to think twice before engaging with Russian monopolies. Russia's shattered credibility might keep it from participating in strategic energy projects in Europe. Hence, Rosatom's plans to expand to the UK market look grim in the short and medium terms, as such an investment is increasingly regarded as controversial at best. Due to Russia's damaged reputation, Rosatom will bid in 2016 probably from a much weaker position for construction of two new nuclear reactors in Czech Republic. In the same vein, the Russian producer of nuclear fuel, TVEL, might lose clients in Europe who may be tempted to reduce their exposure to Russia.

It is not an easy task to assess the impact of sectoral sanctions in the **defence field**. The defence industry and arms acquisitions comprise a less transparent area, unlike the banking or energy sectors. An overview based on available sources and expert evaluations leads to the conclusion that the sanctions have both direct and indirect effects on Russia's military sector. The sanctions will create problems in the fulfilment of the state arms procurement programme till 2020. They are also indirectly responsible for Russia's military budget reduction of 5.3% in 2015.<sup>41</sup>

In reporting the level of execution of arms acquisitions at 38% in the first half of 2015, top military brass invoked among other reasons the Western sanctions for delays in programme fulfilment. In particular, electronic components imported from the West were described as critical for a wide array of weapons and defence equipment.<sup>42</sup> Restrictions on imports of spare parts and primary sources delayed in 2015 the production of "BE-200 amphibious aircraft, Vikhr anti-tank missiles, remote control and radio monitoring equipment for Igla surface-to-air missiles, [and] weapon launch systems for TU-160 strategic bombers."<sup>43</sup> Although the deal

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<sup>41</sup> C. Caffrey, "Russia cuts 2015 defence spending," *Jane's Defence Industry*, 15 June 2015, [www.janes.com/article/52309/russia-cuts-2015-defence-spending](http://www.janes.com/article/52309/russia-cuts-2015-defence-spending).

<sup>42</sup> "Putinu dolozhili o chastichnom sryve Gosoboronzakaza-2015 iz-za sanktsiy Zapada," *Newsru*, 16 July 2015, [www.newsru.com/russia/16jul2015/goz.html](http://www.newsru.com/russia/16jul2015/goz.html).

<sup>43</sup> A. Dolgov, "Russian military struggling to modernize," *The Moscow Times*, 17 July 2015, [www.themoscowtimes.com/article/525782.html](http://www.themoscowtimes.com/article/525782.html).

between Paris and Moscow to cancel delivery of two Mistral-class amphibious assault ships to Russia in 2015 was not directly linked to the EU sanctions (as the restrictions apply to future contracts), plans to build two more ships of a similar class jointly by French firm DCNS and Russia's Shipbuilding Corporation were invalidated by the sectoral restrictions. Russia voiced the intention to launch production of its own helicopter carriers tentatively by 2020. Dwindling funds and the defence industry's weak capacity to carry on such projects, however, may keep the designs for new helicopter carriers just on paper.

The sanctions also imperilled other defence projects scheduled through 2020. Russia put off projects to build eight new-generation Gremyashchy-class corvettes because their diesel engines were supposed to be imported from German company MTU (only two have been delivered). With no engines (currently under development) and short of cash, Russia resumed construction of the older Steregushchy-class corvettes at the Severnaya shipyard.<sup>44</sup> Nevertheless, military experts recognise that even if the new generation of corvettes will be built in the future, without German engines these will have inferior characteristics in comparison to Western analogues.<sup>45</sup> Due to the delays, there are doubts about whether the new class of corvettes will be ready by 2020 as scheduled in the acquisition programme. Another project that has fallen victim to the sanctions is the Kamaz "Typhoon" (53949) armoured vehicle. Designed at the request of the Ministry of Defence for support of infantry, paratroopers and marines, the Typhoon relies on modules and parts from the U.S., Ireland, Germany, Israel and France. Apparently, the armed forces gave up on the project, though a modified version with domestic components might be delivered to interior troops.<sup>46</sup> Similar problems will be encountered in the production of IL-103 trainer aircraft (the engine is from U.S.-based Teledyne Continental Motors) or Ansat (which

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<sup>44</sup>"Verfi Severo-Zapada zamorozili stroitelstvo 17 korably na obshchuyu summu 227 mlrd rubley," *DP*, 16 March 2015, [www.dp.ru/a/2015/03/16/Korabli\\_postojat](http://www.dp.ru/a/2015/03/16/Korabli_postojat).

<sup>45</sup> Author's interview with a Russian military expert, 2015.

<sup>46</sup> S. Grishenko, "KAMAZ-53949 'Taifunenok' pereimenuyut v 'Patrul-A' i otravyat vo vnutrenniye voyska MVD Rossii," *ABW*, 11 January 2015, [www.abw.by/news/180039](http://www.abw.by/news/180039).

uses an engine from Canadian firm Pratt & Whitney) and Ka-226 (engine from French firm Turbomeca) helicopters.<sup>47</sup> The worsening economic situation has pushed Russia to drastically cut acquisitions of fifth-generation T-50 PAK FA Sukhoi fighter jets by 2020 from the 52 it had planned to only 12.<sup>48</sup>

Sanctions in the defence sector have not only disrupted the state arms acquisition programme but risk halting the modernisation of Russia's military-industrial complex. Reportedly, Almaz-Antey, which along with other weapons produces the medium range BUK surface-to-air missile system (which was used to shoot down Malaysia Airlines Flight 17 over Donbass in 2014), has been modernising its factories and importing machines and components from Germany and Sweden (e.g., Hermle, Trumatic, Trumpf, Plymovent). The Severnyi shipyard and other assets serving the Russian navy also use foreign equipment in their production processes. In light of the sanctions, they seem unlikely be able to continue modernisation and could face problems with machine maintenance.<sup>49</sup>

The sectoral restrictions have also suspended dual-use high-tech projects developed by Russian companies jointly with Western partners. A new factory for laser technologies to be built in Novosibirsk by IPG Photonics from the U.S. was put on ice in 2015. In addition to the cancelation of unspecified projects with Rostec (probably in avionics), French firm Safran scaled back plans to develop a joint project with Russian company Promsviazikapitala in the field of biometrics.<sup>50</sup> The restrictive measures have also touched the civil aircraft industry because of the prohibition on the exports of dual-use equipment or technology to Russia. For instance, since December 2014 French defence firm Thales Avionics

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<sup>47</sup> See: "Rabochaya vstrecha s Zamestitelem predsedatelya pravitelstva Dmitriyem Rogozinyem," Kremlin, 3 August 2015, <http://kremlin.ru/events/president/news/50091>.

<sup>48</sup> See: "Nazvan vozmozhnyy obyem zakaza na istrebiteli T-50," *Lenta*, 14 July 2015, <http://lenta.ru/news/2015/07/14/pakfa>.

<sup>49</sup> See: A. Alikin, "Almaz-Antey ne vyderzhal sanktsiy ES," *Fontanka*, 22 May 2015, [www.fontanka.ru/2015/05/22/133](http://www.fontanka.ru/2015/05/22/133).

<sup>50</sup> M. Kormiltseva, "Stroitelstvo novosibirskogo zavoda lazernykh sistem otlozheno iz-za sanktsiy," *RBK*, 10 March 2015, <http://nsk.rbc.ru/nsk/10/03/2015/5592b4879a7947e00d5b5e85>; M. Kolomychenko, "Frantsuzskaya biometriya meniyetsya v litse," *Kommersant*, 29 June 2015, [www.kommersant.ru/doc/2757245](http://www.kommersant.ru/doc/2757245).

has not been delivering electronic systems for the Sukhoi SuperJet-100, which is 40% imported parts.<sup>51</sup> Similarly, Canadian firm Bombardier cancelled plans to produce jointly with Rostec the Q400-NG aircraft in Ulyanovsk.<sup>52</sup>

Overall, the sanctions in the military sector most probably will drain Russia's state funds for import replacement programmes in the medium term and will delay arms modernisation. As a side effect of the restrictions, the technological gap between the West and Russia in the defence sector is set to widen in the long term.

### **On an Island**

The sanctions on Crimea have aggravated the economic situation on the peninsula, making Russia's task to absorb it costly. The restrictions disrupted trade, forced Western and even Russian companies to leave and have so far kept major Russian enterprises from venturing in. The sanctions were particularly painful for the banking, transportation and tourist sectors.

Crimea's exports to the EU during the last decade oscillated between 20% and 28%. In some cases, Crimean companies' reliance on exports to the EU reached 35%.<sup>53</sup> Even before the sanctions were enacted, trade with the EU was on the decline. In the first quarter of 2014, exports from Crimea to the EU shrank by 20%. Later that year, exports from Crimea to the EU without accompanying Ukrainian documents were prohibited. Thus, by the end of 2014, Crimean statistical agencies reported a 90% drop in trade with the EU.

In late 2014, the U.S. president issued an order pushing businesses (including IT and online traders) to evacuate or stop operations in Crimea by February 2015.

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<sup>51</sup> N. Soloviov, "Proizvoditel Sukhoi SuperJet-100 predupredil o riskakh s postavkami oborudovaniya iz-za sanktsiy," *Slon*, 18 August 2015, <https://slon.ru/posts/55240>.

<sup>52</sup> G. Polek, "Bombardier Shelves Plans for Russian-built Q400s," *AInonline*, 30 October 2014, [www.ainonline.com/aviation-news/2014-10-30/bombardier-shelves-plans-russian-built-q400s](http://www.ainonline.com/aviation-news/2014-10-30/bombardier-shelves-plans-russian-built-q400s).

<sup>53</sup> "Crimea risks losing 35% of export market on EU sanctions," *Tass*, 2 July 2014, <http://tass.ru/en/russia/738637>.

Some U.S. companies left Crimea before the publication of directives of the U.S. government. Restaurateur McDonald's decided to quit Crimea and Exxon Mobil, the leader of an international consortium for the exploration of the Skifska gas field near Crimea, pulled out of the project. Soon after, Google, Skype, oDesk, Elance, eBay, Steam and Apple ceased operations in Crimea in December 2014, while MasterCard and Visa suspended operations of its cards on the peninsula. Western banks and other international payment systems curtailed service of transfers to Crimea, too. As a side effect of the sanctions, Chinese internet shopping company AliExpress (part of the Alibaba Group) suspended operations for customers from Crimea.<sup>54</sup> By mid-2015, Russia had managed to re-establish some domestic payments with MasterCard in Crimea, and U.S. IT companies (e.g., Apple, Google) were allowed to resume certain services for users in Crimea to enhance communication with the outside world.

Russia's champion in money transfer services, Golden Crown, exited Crimea to avoid the political risks related to the sanctions and preserve access to the Ukrainian market. Russia's main banks present in Crimea (e.g., Sberbank, VTB, Bank of Moscow) via Ukrainian subsidiaries, sold their businesses, citing the risk of much harsher Western sanctions. Crimean businesses' complaints show that Russian financial institutions not represented on the peninsula were also reluctant to provide loans to economic agents in Crimea, probably out of the same concerns. As of February 2015, there were 28 Russian banks in Crimea, overwhelmingly not those from the top of Russia's bank rankings and with dubious reputations. For instance, in October the RCB withdrew the license of Doninvest (which operated in Crimea) for engaging in highly risky operations. Some banks saw only a few months of activity before closing their offices in Crimea (e.g., Promregionbank) after discovering the potential risks of the sanctions imposed on Crimea. Having nothing to lose after being hit heavily by the Western sanctions, Bank Rossiya, the biggest player from Russia, remains active in Crimea's banking sector. Still, Russian financial institutions have not

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<sup>54</sup> I. Ryabova, "Krupneyshiy internet-magazin Kitaya otkazalsya obsluzhivat Krym," *Slon*, 18 September 2015, <https://slon.ru/posts/56683>.

deployed the firepower to Crimea necessary to invigorate the private sector in the region, leaving it to the responsibility of the government in Moscow.

The transport and tourism sectors took a big hit under the impact of the sanctions. Previously, Turkish Airlines, AtlasJet, WizzAir, Austrian Airlines, Belavia and Air Baltic flew to Crimea. In 2014, Simferopol International Airport ceased to be international, operating only flights between Russia and Crimea (but still considered “international” as *de jure* Crimea is part of Ukraine). Russia’s attempts to make trips to Crimea for Russians more affordable failed as Aeroflot’s low-cost company Dobroliot was blacklisted by the EU. Hence, less than two months after operating its first flight to Crimea in June 2014, Dobroliot terminated activity as its leasing agreements for aircrafts were revoked and foreign partners refused to provide maintenance service. Aeroflot in September 2014 launched another low-cost company, Pobeda, which however refrained from flying to Crimea. In 2015, Russian oil company Tatneft gave up plans to develop an air carrier subsidiary, YuVT-avia, which could have included Crimea among its destinations. The threat of sanctions to its main business activity worked as an effective deterrent.<sup>55</sup>

Instead of flights, low-budget tourists from Russia had to rely on Kerch-based ferry services to get to Crimea. However, in 2014, it only had capacity to transport both ways around 30,000 people a day and no more than 5,000 cars in favourable weather conditions. Huge queues (of nearly 1,500 cars) and brawls between tourists waiting for the ferry (in some cases, for more than 24 hours) proved that Kerch’s ferry capacity did not match the demand. Many Russian citizens became discouraged from spending their holiday in Crimea because of the long waits for the ferry under the blazing sun. The transportation bottlenecks in Crimea, along with other factors (e.g., no Ukrainian tourists, poor quality of services), reduced the number of tourists in Crimea from around 6 million in 2013 to 3.8 million in

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<sup>55</sup> D. Suleimanov, “Aviakompaniya ‘Tatnefti’ ne podoshla dlya poletov v Krym iz-za riska sanktsiy k neftyanikam,” *Vedomosti*, 10 July 2015, [www.vedomosti.ru/business/articles/2015/07/10/600092-rosaviatsiya-vidala-sertifikat-ekspluatanta-tatarstanskoi-yuvt-aero](http://www.vedomosti.ru/business/articles/2015/07/10/600092-rosaviatsiya-vidala-sertifikat-ekspluatanta-tatarstanskoi-yuvt-aero).

2014.<sup>56</sup> This number might increase in 2015 due to the expansion of Simferopol airport's capacities and improvements in the Kerch Strait ferry service.

The sanctions also contributed to a decline in freight turnover through Crimean sea ports by 29% in the first 10 months of 2014.<sup>57</sup> Another bright sub-sector before annexation, cruise tourism (30% growth in 2013), practically ceased to exist in Crimea. In 2013, 185 cruise liners visited Crimea carrying 105,000 tourists on board. In 2014, there were 204 applications from Europe for cruise liners to enter Crimea ports and only one Greek liner, Ocean Majesty operated by Germany's Hansa Touristik, anchored in Yalta.<sup>58</sup>

With Russia striving to build direct transportation and energy links with Crimea (namely a bridge across the Kerch Strait), the companies it has contracted to complete the tasks will face obstacles to implement such challenging projects due to the sanctions on Crimea in the construction sector. To succeed, Russian companies will need Western equipment and to some extent mega parts. The telecommunications sector has also felt the hit of the sanctions. The launch of a second mobile operator in Crimea, Krymtelecom, has been postponed due to obstacles to importing equipment produced by Swedish firm Ericsson.<sup>59</sup>

Overall, despite the annexation of Crimea taking place under the slogan "Crimea is ours," many of Russia's private and public companies behave as if the peninsula is not part of Russia's economic sphere. Observing rampant corruption and lawlessness, many in Crimea seem not to be very enthusiastic about the "return to home." With few economic opportunities, Crimea diplomats

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<sup>56</sup> See: A. Laletina, "Krymchane ne zametili pritoka turistov," *Slon*, 12 August 2015, <https://slon.ru/posts/55060>.

<sup>57</sup> "Porty okkupirovannogo Kryma mogut ostanovitsya," *Liga biznes*, 2 April 2015, <http://biz.liga.net/all/transport/novosti/2979743-porty-okkupirovannogo-kryma-mogut-ostanovitsya.htm>.

<sup>58</sup> "Taksist v Krymu imeyet 600 tys. rubley za sezon," *Gazeta*, 19 March 2015, [www.gazeta.ru/business/2015/03/17/6603113.shtml](http://www.gazeta.ru/business/2015/03/17/6603113.shtml).

<sup>59</sup> A. Laletina, "Sanktsii priostanovili zapusk vtorogo sotovogo operatora v Krymu," *Slon*, 21 September 2015, <https://slon.ru/posts/56774>.

that go unrecognised abroad, and almost no chance to get a U.S. or EU visa,<sup>60</sup> the young and active population of Crimea prefers to migrate (in particular, high-quality specialists) to the mainland (Ukraine or Russia) in search of a better life. Emigration from the peninsula is confirmed by “local authorities,” who decry the creeping outflow of specialists from Crimea.<sup>61</sup> The degradation of human capital signals that Crimea might follow the path of other Russian economically depressed and depopulated regions. However, occasional protests in Crimea (e.g., in Gurzuf in July 2015) show that even emigration of the most active members of the population does not guarantee social peace on the peninsula.

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<sup>60</sup> See the cases of visa applications declined by the German embassy in Moscow for inhabitants of Crimea with Russian passports: V. Vasiliu, “Ambasada Germaniei la Moscova îi trimite pe locuitorii Crimeei după vize la Kiev,” *Adevarul*, 11 September 2015, [http://m.adevarul.ro/moldova/actualitate/ambasada-germaniei-moscova-iitrimite-locuitorii-crimeei-vize-kiev-1\\_55f2cd3ef5eaafab2c7ea465/index.html](http://m.adevarul.ro/moldova/actualitate/ambasada-germaniei-moscova-iitrimite-locuitorii-crimeei-vize-kiev-1_55f2cd3ef5eaafab2c7ea465/index.html).

<sup>61</sup> “Zhiteli Kryma pokidayut poluostrov iz-za nizkih zarplat,” *Kommersant*, 16 July 2015, [www.kommersant.ru/doc/2769206](http://www.kommersant.ru/doc/2769206).

# ACCLIMATISATION TO SANCTIONS

The sanctions and counter-measures Russia applied to sanctioning states chopped away in the short term up to 1.5% of Russia's GDP.<sup>62</sup> In this context, it is important to explore how Russia adjusted to the cost of the sanctions and whether the counter-measures paid off. Russia and its governing elites embarked on both open and covert campaigns to undermine the effectiveness of the sanctions, to prevent new West-imposed restrictions and to remove old ones. These efforts spilled over into the domestic and foreign policy domains, accentuated current trends, revived old practices and initiated new ways of operating.

## Let's Scrap the Sanctions and Do Business

The individual sanctions initially were greeted with defiance and exuberant patriotic zeal. The upper house of the Russian parliament adopted a declaration that called for extending the sanctions to all members of the chamber. Influential presidential aid Vladislav Surkov described his presence on the blacklist as a "recognition of [his] service to Russia" and labelled it a "political Oscar."<sup>63</sup> Deputy PM Rogozin boasted characteristically that "tanks do not need visas," and the president's friend Gennady Timchenko pledged to endure patiently the troubles caused by the sanctions.<sup>64</sup> These and other public reactions were meant to serve as declarations of loyalty to the Russian president, whose popularity in the

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<sup>62</sup>"IMF says Western sanctions could cut 9% off Russia's GDP," *Euractiv*, 4 August 2015, [www.euractiv.com/sections/europes-east/imf-says-western-sanctions-could-cut-9-russias-gdp-316776](http://www.euractiv.com/sections/europes-east/imf-says-western-sanctions-could-cut-9-russias-gdp-316776).

<sup>63</sup>"Surkov rastsenivayet sanktsii SShA kak priznanie svoikh zaslug pered RF," *RIA Novosti*, 17 March 2014, <http://ria.ru/world/20140317/999907314.html>; "Surkov considers his inclusion in US black list equal to Oscar award," *Itar-Tass*, 19 March 2014, <http://tass.ru/en/world/724382>.

<sup>64</sup>"Russian Official: 'Tanks Don't Need Visas,'" *Defence News*, 25 May 2015, [www.defencenews.com/story/defence/international/europe/2015/05/25/russian-official-tanks-need-visas/27924351](http://www.defencenews.com/story/defence/international/europe/2015/05/25/russian-official-tanks-need-visas/27924351).

aftermath of Crimea's annexation was propelled to new political highs. Behind closed doors, though, the political class and business people have shown less enthusiasm about the restrictions imposed by the West. Reportedly concerned about the real consequences of the sanctions on their businesses, oligarchs have flocked to the Kremlin, spending hours in a reception room and sometimes without being received by the president.<sup>65</sup> European diplomats also confessed that Russian officials were making rounds of calls to European embassies inquiring whether they might be blacklisted, too.<sup>66</sup>

Many among the Russian elite were simply unaware of how far the sanctions regime on Russia would go in just one year and that it would last for so long. Slow to grasp the new reality, they changed tone and initiated new measures. The Russian ruling class became more outspoken, unveiling frustration with the troubles created by the sanctions. Russian MPs drastically changed their attitude towards the sanctions, demanding the sanctioning states annul restrictions against members of parliament and participants from delegations to international forums. There were individual appeals as well. Russian MP Mikhail Degtyarev wrote to the EU Delegation in Moscow complaining that the sanctions violated his freedom of movement and barred him from travelling abroad, even as a fencing coach for sport events.<sup>67</sup> Arkady Rotenberg and Dmitri Kiselyov went further by contesting the sanctions in the European Court of Justice.

Covertly, the Kremlin nudged its political (far-right or far-left) friends in Europe to plead as well for the sanctions' removal.<sup>68</sup> For instance, in April 2014, the leader

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<sup>65</sup> Author's interview with a Russian investigative journalist, 2015; Author's interview with a German diplomat, 2014.

<sup>66</sup> E. Servettaz, "A Sanctions Primer: What Happens to the Targeted?," *World Affairs*, July/August 2014, [www.worldaffairsjournal.org/article/sanctions-primer-what-happens-targeted](http://www.worldaffairsjournal.org/article/sanctions-primer-what-happens-targeted).

<sup>67</sup> "Deputat Gosdumy ot LDPR trebuyet snyat s nego evropeyskiye sanktsii," *Flynews24*, 5 August 2015, <http://flynews24.ru/news/538346.html?country=&cat=>.

<sup>68</sup> For more on links between the European far right and Russia, see: M. Laruelle (ed.), *Eurasianism and the European Far Right: Reshaping the Europe-Russia Relationship*, Boulder, Lanham, 2015; I. Tkachiev, G. Makarenko, A. Sukharevskaya, "S kem Rossiya druzhit v Evrope," *RBK*, 23 July 2015, <http://top.rbc.ru/politics/23/07/2015/55a64f5b9a7947a34514662f>.

of Austria's Freedom Party (with wide connections to Russia)<sup>69</sup> criticised the Western sanctions against Russia and invited Europe to "show understanding of Russian interest."<sup>70</sup> The leader of the Northern League from Italy had a similar mission while visiting Moscow and Simferopol in October 2014. Russia has found support among representatives of Europe's mainstream parties as well. For instance, the leader of the Republicans in France portrayed the annexation of Crimea as an expression of the free will of the population living on the peninsula. Another member of the French Republicans, during his trip to Simferopol in July 2015, organised by the Association for Franco-Russian Dialogue, co-presided by former CEO of Russian Railways Vladimir Yakunin (who is on the U.S. blacklist), advocated against continuing the sanctions. On the left side of the political spectrum, the leader of Just Russia, Sergey Mironov, engaged with European Socialists to advocate the suspension of individual sanctions.<sup>71</sup>

Besides instrumentalising friendships, Russia relied on lobbyist activities. Novatek, blacklisted by the U.S., employed a public-relations company based in Washington, D.C., in 2014 to attempt to water down the sanctions. The Russian president did his part too, appealing to Western audiences in accessible language. In demonising the sanctions against his friends, President Putin labelled the restrictions as violations of human rights. Occasionally Russia employed more brutal discourse to try to intimidate EU Member States. After Chairman of the State Duma Sergey Naryshkin was barred from Finland, Russia threatened to retaliate with timber trade restrictions, but to no avail.

Mimicking the sanctions was another part of Russia's strategy aimed at showing resilience and challenge the consensus on sanctions inside the EU. The

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<sup>69</sup> See: for example: A. Shekhovtsov, "Freedom Party of Austria: pro-Russian far right lobbyists and merchants of deception," Shekhovtsov blog, 20 June 2014, <http://anton-shekhovtsov.blogspot.com/2014/06/freedom-party-of-austria-far-right.html>.

<sup>70</sup> Ch. Hawley, "A Partner for Russia: Europe's Far Right Flirts with Moscow," *Spiegel*, 14 April 2014, [www.spiegel.de/international/europe/european-far-right-developing-closer-ties-with-moscow-a-963878.html](http://www.spiegel.de/international/europe/european-far-right-developing-closer-ties-with-moscow-a-963878.html).

<sup>71</sup> "Vstrecha s liderom partii 'Spravedlivaya Rossiya' Sergeyem Mironovym," Kremlin, 29 July 2015, <http://kremlin.ru/events/president/news/50071>.

Kremlin mirrored the EU's travel blacklist with its own (with 89 Europeans on it),<sup>72</sup> a list which was revealed after a German MP was refused entrance to Russia in mid-2015. Moscow hinted that a mutual scrap of the blacklists could be a way out. But there is no grounds for such an exchange as the EU's list is compiled based on precise criteria and in tune with international law, namely violation of Ukraine's sovereignty and territorial integrity, whereas Russia's is a rather arbitrary compilation of former or current EU Member State officials who, in the Kremlin's reading, were engaged in actions that damaged Russian interests (e.g., denounced corruption and human rights violations, condemned the annexation of Crimea, supported LGBT rights in Russia, criticised Russia's "peacekeeping" operations in the post-Soviet region).<sup>73</sup>

Sanctions violations, avoidance (using legal loopholes) or even profit-making were part of the acclimatisation strategy as well. In addition to the unauthorised flight to Moldova via Bulgaria and Romania, Rogozin was involved in another travel incident. Despite early warnings from Oslo, in April 2015 he made a short detour to the Svalbard archipelago on his way to a drifting Russian scientific station near the North Pole. Norway's position on travel restrictions for blacklisted people was rebuffed by the Russian side, which referred to a 1920 treaty on the Svalbard archipelago (known as Spitzbergen) that allows all signatories to have unrestricted access to the territory. This incident compelled Norway to upgrade legislation allowing authorities to expel from the archipelago anyone who is on a sanctions list. Russia tested the sanctions and the Western reaction. In this context, Russia's aim was to demonstrate that the sanctions regime can be violated and it can get away with what it wants to do. In parallel, the Russian official exploited this episode for domestic consumption in an effort to augment his own popularity and patriotic feelings amidst the anti-Western rhetoric.

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<sup>72</sup> "The complete blacklist of EU officials banned from Russia," *Euronews*, 2 July 2015, [www.euronews.com/2015/06/02/the-complete-blacklist-of-european-officials-barred-from-entering-russia-putin](http://www.euronews.com/2015/06/02/the-complete-blacklist-of-european-officials-barred-from-entering-russia-putin).

<sup>73</sup> For more, see: G. Dudina *et al.*, "I drugiye nezhelatelnyye litsa," *Kommersant*, 2 July 2015, <http://kommersant.ru/doc/2739315>.

The chairman of the Russian Duma relied on UNESCO and Council of Europe invitations to travel despite the sanctions, visiting Paris once and Strasbourg twice between 2014 and 2015. Although Naryshkin was not received by French officials, he scored symbolic political points by entering the EU several times despite the restrictions on him. He also paid a visit in May 2014 to Serbia to underscore that not all the states in Europe that seek close relations with the EU were aligned with the sanctions on Russia. Two Russian MPs backlisted in the EU (Yuri Vorobyov and Vladimir Dzhubarov) after securing an invitation from a Swiss-Russian parliamentary group, made it legally to Switzerland in June 2015.<sup>74</sup> In September 2015, on humanitarian grounds singer Iosif Kobzon (also on the blacklist) received an Italian visa for medical treatment. As in previous cases, the Russian side intended to abuse the exemption on the travel ban to prove that by playing with various legal regimes, blacklisted people still can enter Schengen states despite the individual sanctions.

### **Shielding the Inner Circle**

The financial sanctions exposed the vulnerabilities in the banking sector. To cover them up, the government ordered the creation of a national payment card system (NPCS) and constrained by law international payment systems working in Russia to localise their card-clearing operations inside Russia using the NPCS. MasterCard and Visa complied and transferred its clearing operations in 2015 to Russia. Since its inception, the NPCS has recorded three major disruptions in its operations (lasting from 15 minutes to 5 hours), during which payments were not processed or were delayed. To further diminish the perceived risks in the banking sector, the government pushed for the issuance of national payment cards called "Mir" (which can be translated as "world" or "peace"). The first cards are scheduled to be issued in December 2015. The RCB estimates that 30 million cards will be issued in 2016. The downside effect of this decision is that according

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<sup>74</sup> S. Hehli, "Nationalrat applaudiert sanktionierten Russen," *Neue Zürcher Zeitung*, 18 June 2015, [www.nzz.ch/schweiz/nationalrat-applaudiert-sanktionierten-russen-1.18565217](http://www.nzz.ch/schweiz/nationalrat-applaudiert-sanktionierten-russen-1.18565217).

to preliminary calculations servicing the “Mir” cards will cost Russian banks more than using Visa or MasterCard via the NPCCS.<sup>75</sup> In late August 2014, the Russian authorities also unveiled plans to set up an internal SWIFT-like system for domestic use and advocated for the creation of a SWIFT-like system between BRICS countries.

Besides the inconvenience to their banks’ credit cards, the wealth of Putin’s inner business circle was trimmed by the sanctions too.<sup>76</sup> According to Forbes’ richest billionaires ranking of 2015, Gennady Timchenko fell 57 positions (to 118<sup>th</sup>), Arkady Rotenberg lost 949 places (to 1,324<sup>th</sup>) and Yuri Kovalchuk dropped out of the billionaires club altogether.<sup>77</sup> Their wealth waned as the rouble weakened, the Russian stock exchange collapsed and, in order to avoid sanctions, some of them sold profitable businesses abroad (e.g., Timchenko’s 44% share in oil trading company Gunvor). But the scale of the meltdown in fortunes should not be exaggerated as Putin’s inner circle tends to camouflage its businesses (using relatives and shadow ownership schemes) and real profits. Therefore, wealth estimations in their case should be regarded as very approximate. Not surprisingly, the sanctions sparked multiple transfers of shares between Putin’s oligarchs, their family members and offshore companies in order to bypass sanctions criteria and thus save the businesses from restriction. For example, Timchenko and Kovalchuk reduced their joint stake in Sogaz to 50%, Timchenko sold or reduced his participation in a fishery (to his son-in-law) as well as aviation and petrochemicals businesses, whereas the Rotenbergs conducted a massive transfer of shares (e.g., Gazprom Drilling and Langvik Capital) to their sons Igor and Roman.<sup>78</sup>

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<sup>75</sup> For more, see: “Vnedrenie karty ‘Mir’ nedeshevo oboydetsya rossiyskim bankam,” *Newsru*, 13 August 2015, [www.newsru.com/finance/13aug2015/mircardimplmntn.html](http://www.newsru.com/finance/13aug2015/mircardimplmntn.html).

<sup>76</sup> For more, see: J. Ćwiek-Karpowicz, S. Secieru (eds.), *Sanctions and Russia*, PISM, Warsaw, 2015.

<sup>77</sup> “Forbes Billionaires List 2015,” *Forbes*, [www.forbes.com/billionaires/list](http://www.forbes.com/billionaires/list).

<sup>78</sup> J. Farchy, “US frustrates Russian oligarchs’ cat and mouse over sanctions,” *Financial Times*, 9 August 2015, [www.ft.com/cms/s/0/3a5326d0-3ce4-11e5-bbd1-b37bc06f590c.html#ixzz3iJj1LFDj](http://www.ft.com/cms/s/0/3a5326d0-3ce4-11e5-bbd1-b37bc06f590c.html#ixzz3iJj1LFDj).

An unintended consequence of the sanctions was that they widened the inner circle's business opportunities in Russia. This was made possible because of generous support from the Russian government, which allocated aid and divvied up lucrative contracts to companies affiliated with the president's inner circle. Although Novatek reported more than a 50% drop in profits in 2014, it received the go-ahead for \$2.8 billion in aid from the National Wealth Fund (NWF) for the Yamal LNG project. Timchenko's Stroitransgaz secured a contract worth \$1.26 billion for the construction of 208 km (Chayanda-Lensk portion) of the "Power of Siberia" gas pipeline to China. As Gazprom struggled to raise funds for the project, Putin ordered support for the pipeline be made from Russia's budget, guaranteeing a steady flow of money towards Stroitransgaz. After Russia banned import of food from sanctioning states, Timchenko expanded into agro-business, acquiring 40% of the shares in Russia's biggest apple producer, Alma Group. Rotenberg's Stroigazmontazh had a prolific 2014 year, as company managed to win 279 tenders out of 374 and increase its earnings by 22%.<sup>79</sup> In 2015, Stroigazmontazh was awarded a \$4 billion contract to build a bridge across the Kerch Strait to Crimea and a 400 km-long gas pipeline from Russia to the peninsula. In 2015, Arkady Rotenberg, along with his business partner (Alexandr Ponomarenko), were very close to securing control over Russia's main airport, Sheremetyevo.

Kovalchuk's Bank Rossiya was re-capitalised with around \$230 million in federal loan bonds (OFZ). Rotenberg's SMP Bank was not part of the government's initial aid scheme, but in 2015, Russia's bank regulator mulled amending criteria so that SMP Bank could become eligible for support, too. The bank benefited from indirect help when the RCB selected it to bail out Mosoblbank (and its subsidiaries) and allocated \$2.8 billion for this purpose from Russia's Deposit Insurance Agency. In 2015, the RCB changed the rules again to allow Bank Rossiya and SMP Bank to attract deposits from non-governmental pension

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<sup>79</sup> "Stroigazmontazh Rotenberga stal krupneyshim podryadchikom v 2014 godu," *Newsru*, 14 July 2015, <http://newsru.com/arch/finance/14jul2015/stroigasroten.html>.

funds. Various forms of state aid helped both banks to boost profits in 2014: Bank Rossiya by 97% and SMP Bank by 82%.<sup>80</sup>

Overall, wider access to state contracts and lavish government-funnelled aid to some extent shielded the inner circle and partially undermined the domestic constraints exacerbated by the sanctions. It also further sealed the dependence of the oligarchs on the president's protection and benevolence. Nevertheless, so-called state oligarchs (CEOs of state corporations with a free hand to manage assets) deemed to be part of the inner circle were treated in different ways by the president. Rosneft's application (headed by Igor Sechin) for cash from the NWF, ostensibly to develop four projects, was turned down. Chemzeov's Rostec instead received additional funds after federal budget amendments in March 2015, and it is waiting for an answer to its application submitted in July 2015 for support from the sovereign wealth fund. Vladimir Yakunin who ran Russian Railways Company (RZhD) for 10 years, amassing a huge fortune (e.g., his personal villa is estimated to be worth \$75 million),<sup>81</sup> was "exiled" in August 2015 to be in Russia's upper house of parliament as a senator from Kaliningrad (a position he surprisingly declined). It has been rumoured that the Rotenberg brothers had prepped a loyal person to take the RZhD seat.<sup>82</sup> All these point to increasing competition within the inner circle for dividends from an economic pie dwindling under the impact of the sanctions. This in turn will require a subtler, dual balancing game on the part of the president, who on the one hand is the indispensable arbiter of conflicts inbuilt into the system, and on the other hand, is the ultimate gatekeeper of reserve funds, vital to diminishing the pressure of sanctions on Russia's economy and, respectively, on its foreign policy, in particular towards Ukraine.

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<sup>80</sup> N. Starostina, A. Koshkarov, *op. cit.*

<sup>81</sup> See: B. Nemtsov, L. Martynyuk, "Winter Olympics in the Sub-Tropics: Corruption and Abuse in Sochi," *Interpreter*, 6 December 2013, [www.interpretermag.com/winter-olympics-in-the-sub-tropics-corruption-and-abuse-in-sochi](http://www.interpretermag.com/winter-olympics-in-the-sub-tropics-corruption-and-abuse-in-sochi).

<sup>82</sup> "Prichinoy ukhoda Yakunina iz RZhD nazvali yego pozitsiyu po povodu subsidiy," *Interfax*, 24 August 2015, [www.interfax.ru/business/462049](http://www.interfax.ru/business/462049).

## Too Big to Ignore

With many doors shut in the West as a result of the political-diplomatic sanctions, Russia has tried vigorously to bulldoze its way back. Russia's foreign and security policy has strived to uphold several narratives, among them that Russia is too big to be isolated, Russia has other alternatives to the West, Russia is a self-standing international player, and the Western powers' interests diverge and ultimately they will have to work with Russia to secure individual national interests. To translate these narratives into practice, the Kremlin's diplomacy was buttressed by a variety of, in some instances, reckless military tactics.

Kremlin raised sabre-rattling to a new level, aiming to induce fear in Europe of a potential military conflict with Russia. Regular warnings about the coming of WWII and nuclear doomsday were backed by multiple military drills across Russia, increasing incidents of violations of NATO and EU Member State airspace, provocative flights or naval training near territorial waters, imitation of nuclear attacks from the air, harassment of military ships and near collisions with civilian aircraft or military jets. According to Russia's Ministry of Defence, in the winter of 2013–2014 (December to May) the Russian armed forces conducted almost 250 exercises, but in the same period in 2014–2015 there were 886 drills.<sup>83</sup> Statistics compiled by NATO show that in 2014 Allied jets carried out 524 interceptions in Europe (an all-time high since the end of the Cold War), with the lion's share (84%) involving Russian aircraft. The trend persisted in the first half of 2015, with NATO jets taking off 245 times to intercept Russian planes.<sup>84</sup> Experts monitoring the military situation recorded between March 2014 and March 2015 a total of

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<sup>83</sup> For more, see: A. Nikolski, "Kolichestvo ucheniy v rossiyskoy armii rezko uvelichilos," *Vedomosti*, 6 May 2015, [www.vedomosti.ru/newspaper/articles/2015/05/06/kolichestvo-uchenii-v-rossiiskoi-armii-rezko-uvlichilos](http://www.vedomosti.ru/newspaper/articles/2015/05/06/kolichestvo-uchenii-v-rossiiskoi-armii-rezko-uvlichilos).

<sup>84</sup> "NATO reports surge in jet interceptions as Russia tensions increase," *The Guardian*, 3 August 2015, [www.theguardian.com/world/2015/aug/03/military-aircraft-interventions-have-surged-top-gun-but-for-real](http://www.theguardian.com/world/2015/aug/03/military-aircraft-interventions-have-surged-top-gun-but-for-real).

66 high-risk, serious or near-routine incidents in the air, on the sea or ground involving Russia and Western states.<sup>85</sup>

While these cases substantially poisoned the atmosphere, they revealed Russia's predisposition to coerce a risk-averse West to restore the blocked links. Russia's officials quite frankly confirm this approach. For example, asked at the Munich Security Conference about what is behind the increasing number of incidents (also involving civilian aircraft), Russia's Minister of Foreign Affairs Sergey Lavrov blamed the reduction in bilateral contacts for "dark spots" in Russia-NATO relations.<sup>86</sup> However, the Russian foreign minister paid no heed in his answer to the possibility of casualties, not only of military personnel but also civilians (including Russian citizens who might be flying with European airlines), that such behaviour might cause.

The increased number of incidents also disclosed some military weaknesses of the Russian armed forces. In June–July 2015, Russia lost six military jets (including a TU-95 strategic bomber) during non-combat missions. Aircraft age, the higher frequency of flights and poor maintenance were listed by Russian experts as the main causes.<sup>87</sup> Therefore, in June Russia had to ground its entire fleet of long-range TU-95s, which had been often used in the provocative flights to the borders of Europe, North America and Japan. Russia's muscle-flexing is not cost-free. It requires the Kremlin to allocate resources to maintain old hardware and produce new ones, which given the sanctions and economic decline becomes more expensive or impossible if imports of replacement parts is not feasible. Although Russia announced in 2015 a decision to add 50 TU-160 supersonic bombers (out of 15 planes in use, 12 are combat-ready),

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<sup>85</sup> T. Frear, "List of Close Military Encounters between Russia and the West," *ELN*, March 2015, [www.europeanleadershipnetwork.org/medialibrary/2015/03/11/4264a5a6/ELN%20Russia%20-%20West%20Full%20List%20of%20Incidents.pdf](http://www.europeanleadershipnetwork.org/medialibrary/2015/03/11/4264a5a6/ELN%20Russia%20-%20West%20Full%20List%20of%20Incidents.pdf).

<sup>86</sup> "Foreign Minister Sergey Lavrov delivers a speech and answers questions during debates at the 51<sup>st</sup> Munich Security Conference," Munich, 7 February 2015, [http://archive.mid.ru//brp\\_4.nsf/0/4E7CDDD252FDEF1F43257DE60031E493](http://archive.mid.ru//brp_4.nsf/0/4E7CDDD252FDEF1F43257DE60031E493).

<sup>87</sup> For more, see: V. Sychev, "Na chestnom slove i na odnom kryle. Pochemu Rossiya teryayet voyennyye samolety?," *Slon*, 8 July 2015, <https://slon.ru/posts/53785>; A. Goltz, "Tragediya v Omske kak simvol oboronogo zakaza," *EJ*, 14 July 2015, [www.ej.ru/?a=note&id=28139](http://www.ej.ru/?a=note&id=28139).

which previously have taken part in provocation missions over Europe or the U.S., it would be a huge financial and logistical challenge to resume production after a break of more than two decades.

On the diplomatic level, Russia has not abandoned attempts to drive a wedge between members of the sanctioning coalition and ascertain its indispensability on major international dossiers. In this endeavour Moscow has resorted often to contradictory means. The Kremlin's speculated talks on the Iranian nuclear programme and need to combat the Islamic State's expansion to re-engage with the U.S. administration. Commenting on the U.S. Secretary of State's visit to Sochi, the head of Russian diplomacy explained that "isolating Russia is not working," whereas the wide range of issues discussed proves that "none can be solved without Russia."<sup>88</sup> In parallel, while demonstrating occasionally that it can be a responsible stakeholder in other corners of the world, Russian diplomacy has tried to downplay Ukraine as an unimportant, irritating matter that hinders bilateral cooperation in tackling effectively more pressing issues for the U.S., such as threats emerging from the Middle East. For instance, after the expansion of U.S. sanctions on Russia for violation of Ukraine's sovereignty (in September 2015), Russia's MFA implied that the sanctions undermine the chances for cooperation on other international issues.<sup>89</sup> Russia's calls to use the positive experience of the talks with Iran to settle other contentious regional problems in an ideologically-free manner may be interpreted as Kremlin's invitation to bargaining on Ukraine in the best Realpolitik tradition.<sup>90</sup> After a 10 year break, in September 2015 President Putin attended a session of the UN General Assembly in New York. Ahead of his visit to the U.S., the Russian side was eager to set up a bilateral

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<sup>88</sup> "RF i SShA vozvrashchayutsya k normalnym otnosheniyam," *MIGnews*, 2 July 2015, [http://mignews.com/news/politic/world/020615\\_133847\\_80726.html](http://mignews.com/news/politic/world/020615_133847_80726.html).

<sup>89</sup> See: "Kommentariy MID Rossii v svyazi s rasshireniem SShA antirossiyskikh sanktsionnykh spiskov," 2 September 2015, [www.mid.ru/foreign\\_policy/news/-/asset\\_publisher/ckNonkJE02Bw/content/id/1726572](http://www.mid.ru/foreign_policy/news/-/asset_publisher/ckNonkJE02Bw/content/id/1726572).

<sup>90</sup> "Zayavlenie Ministra inostrannykh del Rossiyskoy Federatsii S.V. Lavrova v svyazi s zaklyucheniem 'Gruppy shesti' i Iranom Sovmestnogo vseobimlyushchego plana deystviy po okonchatelnomu uregulirovaniyu situatsii vokrug iranskoy yadernoy programmy," *MID*, 14 July 2015, [www.mid.ru/press\\_service/minister\\_speeches/-/asset\\_publisher/7OvQR5KJWVmR/content/id/1581404](http://www.mid.ru/press_service/minister_speeches/-/asset_publisher/7OvQR5KJWVmR/content/id/1581404).

meeting with the U.S. president. In preparation for the eventual encounter, Russia boosted its military footprint in Syria. Shortly after the meeting of the two presidents, Russian jets launched its first airstrikes in Syria, apparently not targeting IS-controlled areas but strongholds of rebels fighting to oust Assad's regime. Hence, Russia has sought to demonstrate its resistance to isolation and its power to disrupt and ultimately to shift U.S. attention from Ukraine to Syria.

With Europe, Moscow actively speculated on phobias about nuclear conflict and played up anti-American sentiments among leftist political movements. Russia's pundits cautioned the EU against sticking to the U.S. approach because in case of a nuclear confrontation Europe would be the main theatre of action. To add more salt to the wound, Russia's foreign-speaking state controlled mass media hyped news about the U.S. intercepting European leaders' phone calls. Russia also kept presenting the EU as an actor deprived of agency. In this logic, the EU introduced sanctions under U.S. pressure and against Europe's economic interests.

The Kremlin launched a hectic campaign to challenge the EU's unity and drive back the sanctions. Counter to an intra-EU agreement not to hold bilateral summits with Russia (unrelated to talks on Ukraine, the "Normandy format"), President Putin since March 2014 has made high-level visits to Austria, Hungary and Italy. In turn, he received in Moscow the presidents of Cyprus, Czech Republic and Finland and the prime ministers of Slovakia and Greece.<sup>91</sup> Thus, Russia was able partially to circumvent the EU's political-diplomatic sanctions. Moscow further strived to divide the EU with proposals to negotiate with individual EU Member States on access for their goods to the Russian market (in an attempt to marginalise the European Commission), made pledges to selectively ease Russia's food embargo, raised prospects of contracts on energy-related projects (gas pipelines and nuclear power plants), made promises of illusory financial assistance and reiterated its grand idea of a Europe from Lisbon to Vladivostok (which Russia discredited by its actions in Ukraine). Russia enrolled European

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<sup>91</sup> The German Chancellor's (part of Normandy format) visit to Moscow on 10 May 2015 was a peace-building effort to calm the conflict in Donbass.

businesses in this endeavour, too. By signing memorandums of understanding or preliminary deals in the energy field (e.g., Turkish Stream or new lines of North Stream), Russia aimed to create the impression that regardless of the political-diplomatic sanctions, it was business as usual in other fields. The Kremlin also cultivated European business community voices to oppose the sanctions. Altogether, these should have sown mistrust and undermined EU solidarity. Notwithstanding the violation of political-diplomatic sanctions and anti-sanction voices in the EU, Russia failed to roll back the sectoral restrictions. Nevertheless, its efforts made holding the EU Member States together on this issue a challenging task.

On the eastern front, Kremlin courted Japan with the prospect of eventual talks on the Kuril Islands and a peace treaty if it eased sanctions and resumed high-level visits postponed after the annexation of Crimea. Russian diplomacy worked hard to put a President Putin visit to Tokyo back on the bilateral agenda. In June 2015, Prime Minister Shinzo Abe confirmed an invitation for Russia's president to visit Tokyo at the most convenient time for both sides.<sup>92</sup> However, Russia's prime minister's trip to the Kuril Islands in August is very likely to make Putin's visit to Japan inconvenient for Tokyo, at least in 2015. The Japanese side notified Moscow about the obstacles a visit to the Kuril Islands may erect for a high-level bilateral dialogue.<sup>93</sup> Besides the irritant to bilateral relations of the Kuril Islands dispute, Russia's recent lean towards China in its foreign policy deprives Moscow of any chance to pursue a careful balancing act, practiced since the early 2000s, between Japan and China in Asia.<sup>94</sup>

Russia also peddled emerging powers narratives to give the appearance of having viable alternatives to the West. Kremlin downplayed its exclusion from

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<sup>92</sup> "Telefonnyy razgovor s Premier-ministrom Yaponii Sindzo Abe," Kremlin, 24 June 2015, <http://kremlin.ru/events/president/news/49758>.

<sup>93</sup> "MID Yaponii somnevayetsya v razvitii dialoga s Rossiyey iz-za poyezdki Dmitriya Medvedeva na Kurily," *Kommersant*, 14 August 2015, <http://kommersant.ru/doc/2789569>.

<sup>94</sup> See: B. Lo, *Russia and the New World Disorder*, Brookings Institution Press/Chatham House, Washington, 2015, pp. 50–51.

the G8 as an outdated format that does not reflect the current distribution of power in the international system. Respectively, the G20, where Russia is present, is portrayed as a better and more inclusive framework to efficiently tackle global problems. In 2015, Russia, as host of BRICS and Shanghai Cooperation Organisation (SCO) summits, made an extra investment to portray the gatherings as viable global and regional mechanisms for dealing with political and economic problems. During the BRICS summit in Ufa, for example, the leaders formally kicked off new financial institutions (the New Development Bank and a currency reserve pool). Also, SCO members, in the organisation's first round of enlargement, invited India and Pakistan to join. Nevertheless, with \$50 billion in initial capital, the New Development Bank lacks the financial firepower to rival the EBRD or World Bank, and SCO's enlargement sparked friction with Central Asia republics (e.g., Uzbekistan), which are dissatisfied with their voice being diluted by the growing number of regional powers in the organisation.

Despite the setbacks, Russia did not abandon its efforts to internationally legitimise the Eurasian Economic Union (EEU), established in January 2015, based on the CU RBK. Although, Russia claims that some 40 states or international organisations are interested in liberalising trade with the EEU, only one agreement to date has been signed, with Vietnam. Moscow invited China to conclude an FTA with the EEU. Instead, Beijing suggested to negotiate a less ambitious trade and economic cooperation agreement and to find ways to link its "Silk Road" initiative with the EEU. The Kremlin wrote off Uzbekistan's debt in 2014, hoping not only to sell it more weapons but to attract Tashkent to open FTA talks with the EEU. Currently, Russia is conducting explorative consultations on an FTA between the EEU and Egypt, India and Iran.

As Moscow was busy promoting the EEU on the international stage, its counter-measures against sanctioning states (namely the food embargo) and rouble devaluation (in part, the outcome of Western sanctions) sparked tensions with Belarus and Kazakhstan. The first signs of disunity surfaced when Belarus and Kazakhstan refused to support Russia's food embargo, depriving the Kremlin of regional backup. The Russian government then announced in November

2014 a limit on the transit of food from Belarus to Kazakhstan and a prohibition of milk and meat imports from 23 companies in Belarus. In violation of CU RBK provisions, Russia as well instituted selective customs and veterinary checks on the border with Belarus and Kazakhstan, accusing both states of re-exporting food from the EU. These decisions, coupled with a rapid weakening of the rouble triggered retaliatory measures from Minsk and Astana. Belarus in December reinstated ad hoc border inspections on incoming transport vehicles from Russia and Kazakhstan temporarily banned fuel imports from Russia and closed its market to a dozen Russian food producers. Although the trade spats to some extent were later extinguished, they exposed the political nature of the EEU and its shaky foundations.

### **Import (Non)-Substitution**

The sectoral sanctions were the most painful punitive measures taken by the West in relation to Russia. These were largely perceived in Moscow not only as tools to narrow Russia's foreign policy options (including in Ukraine) but also an open attempt to inspire regime change in Russia. Guided by this outlook, Kremlin has resorted to administrative tools, economic stimulus, counter-measures against sanctioning states, evasion tactics and information manipulation. The general scope was to demonstrate resilience, limit the damage and make the whole sanctions affair pay domestic political dividends. While the Kremlin was partially successful in the political field, the counter-measures brought Russia more pain than gain. Moreover, the import replacement rush triggered by the sectoral sanctions devoured Russia's reserves with little advantage for a rapidly closing economy.

One set of reactions comprised legal challenges, lobbyist activities and trade warfare against the sanctioning states. Russia's banks, defence industry conglomerates and energy giants attacked the sanctions in courts or tried to dilute them through lobbying. In October 2014, Rosneft filed a lawsuit in London's High Court to halt the UK's application of the sanctions, but to no

avail.<sup>95</sup> Gazprombank and VTB hired lobbying firms in the U.S. to soften the sanctions, but they have had zero effect so far. At the same time, Sberbank, VTB, VEB, Gazprom Neft, Rosneft and Almaz-Antey appealed to the European Court of Justice to repeal the sanctions. The rulings are unlikely to be speedy, as an examination of the cases could last several years.

Legal means to abolish the sectoral sanctions were accompanied by sectoral counter-measures calculated to increase the costs of the sanctions for the West and thus shake the political will to maintain them. In August 2014, Moscow announced a food embargo against states involved in the sanctions regime on Russia. The embargo was extended for one more year in June 2015 and expanded in August to include Albania, Montenegro, Iceland and Liechtenstein. The primary target of the food embargo was the EU, which directed 10% of its agricultural exports to Russia in 2013 (4 percentage points of such exports are now covered by the restrictions). However, the counter-measures backfired, leaving the EU instead relatively unharmed. On the EU side, in one year's time, agricultural exports grew by 5% due to the flexibility of farmers to re-direct exports (e.g., 15% more to the U.S., 30.8% more to South Korea, 21.7% more to Egypt) and EU Commission assistance to lift trade barriers (e.g., to China, Canada, and Japan).<sup>96</sup> The EU's targeted compensatory measures also helped to mitigate the effects of Russia's embargo.

On the Russian side, the food embargo drove food inflation (16.7% in 2014; 10.6% in the first half of 2015), hitting particularly hard a vulnerable strata of the population relying on cheap products.<sup>97</sup> The government sent prosecutors to inspect food prices in retail centres and supermarkets. By March 2015, prosecutors had launched nearly 1,500 cases in connection with what were

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<sup>95</sup> "London's High Court blocks bid by Rosneft to halt sanctions," Russian Legal Information Agency, 28 November 2014, [http://rapsinews.com/judicial\\_news/20141128/272677347.html](http://rapsinews.com/judicial_news/20141128/272677347.html).

<sup>96</sup> "The Russian ban on EU agricultural products—12 months on," EU Commission, 6 August 2015, [http://ec.europa.eu/agriculture/newsroom/218\\_en.htm](http://ec.europa.eu/agriculture/newsroom/218_en.htm).

<sup>97</sup> "Продукты в России за полгода подорожали больше чем на 10%," Slon, 25 August 2015, <https://slon.ru/posts/55524>.

deemed as unjustified price hikes, but the statistics on food inflation show the coercion had little payoff. In parallel, the authorities tried to sell the food embargo as chance for farmers and agro-entrepreneurs to boost profits and contribute to import substitution in the food sector. The government turned to administrative means and subsidies to encourage the process. The first session of a government commission on import replacement in August 2015 was dedicated, predictably, to agriculture. The federal centre put aside almost \$800 million in 2015 to support agriculture.

But Russia's achievements are quite modest. Russian domestic producers were able to selectively increase production (e.g., cheese, meat, fish) but the results came at a cost, namely by reducing quality. For example, the Union of Consumers of Russia declared that tests revealed that 60% of cheese and butter on the Russian market did not meet quality standards.<sup>98</sup> The increase in production in certain categories still does not signal a systemic change in the agricultural sector. The weakening rouble (thus high interest rates), unpredictable business environment, lower domestic consumption, and reliance on Western equipment or know-how hampered import substitution on a wide scale. The agricultural sector requires long-term investments that go far beyond a one or two-year timeframe. Unsure of how long the food embargo will stay in place, Russian agro-producers are reluctant to commit new investments.

In assessing the impact of the financial sanctions, a Russian statesman recognised that, "they deprived Russia of long-term money, instead, we have now to focus on domestic resources, which are, however, not limitless."<sup>99</sup> From two of Russia's sovereign wealth funds, its Reserve Fund (RF) and NWF (both of which comprise part of the country's international reserves), almost \$87 billion each as of August 2014 served this purpose. After being shut off from Western long-term lending markets, Russian companies and banks lined up to apply for government emergency aid or funds to continue projects. One year after the enforcement of

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<sup>98</sup> "Boleye 60% syra i slivochnogo masla v Rossii priznano falsifikatom," *Gazeta*, 7 September 2015, [www.gazeta.ru/business/news/2015/09/07/n\\_7564625.shtml](http://www.gazeta.ru/business/news/2015/09/07/n_7564625.shtml).

<sup>99</sup> Remarks by a Russian official during debate, 2015.

the financial sanctions had begun, Russia's sovereign funds totalled \$10 billion less each, indicating that the government had unsealed the reserves to diminish the effects of the sanctions and declining oil prices. For instance, the government earmarked from the NWF almost \$16 billion for systemic bank recapitalisation in 2015. Apparently, state banks (e.g., VEB and Novikombank) are manoeuvring to receive more state aid in 2016, too. This, however, would further increase the state's role in the economy and force the Russian government to assume more commercial risks that should be the responsibility of the private (corporate) sector. "I do not think, more state in the economy is a good way out. It diminishes initiative and entrepreneurship," confessed one Russian official.<sup>100</sup>

To slow the depletion of the country's financial reserves, the government cast its eyes on private pension funds. In 2014, citizens' contributions to private pension funds (up to \$8 billion) were retained to cover budget holes. In 2015, the executive mulled re-channelling the contributions to finance big state or private infrastructure projects. While this move would undermine the sustainability of Russia's pension system in the long term, it also would withdraw substantial liquidity from the financial market that otherwise could be a source of investment in Russia's private sector.

Import-substitution logic reached Russia's financial sector, too. The RCB pushed hard to institute a parallel Russian national rating agency that allegedly would ascribe more objective ratings to Russian companies than the "Big Three" (S&P, Moody's and Fitch). It should become operational in 2015 and tentatively produce its first ratings in mid-2016.

Aware of its limited domestic reserves, Moscow looked to Asia for an alternative flow of money. China was identified by the Kremlin as a player that could help moderate the impact of the sectoral sanctions in the financial and energy domains. To this end, the political dialogue at the highest level was rekindled in 2014 and Russia enthusiastically joined the Chinese-led Asian Infrastructure Investment Bank (AIIB). Hoping to draw money from the AIIB, Moscow also

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<sup>100</sup> *Ibidem.*

explored ways to attract investments from China within a “Silk Road”-EEU cooperation framework, which was proposed in 2015. Particular attention on the Russian side was paid to attracting Chinese investment in agriculture, transport infrastructure and energy. In addition, the Russian government raised the issue of mutual investments in sovereign bonds, with Moscow aiming to tap into China’s huge financial reserves.<sup>101</sup>

For now, China has not become a main “capital substitute” for Russia. After stagnating for two years in a row (at around \$4 billion or 6% of all FDI in Russia), Chinese direct investments in Russia collapsed, falling by 25% in the first half of 2015.<sup>102</sup> Of the many MoUs signed in 2014 and 2015, few materialised as legally binding documents.<sup>103</sup> China eschewed some of Russia’s offers while prudently involved itself in other projects.<sup>104</sup> For instance, China has shown little interest to join the LNG factory project in Vladivostok. Nevertheless, it has moved ahead with the Yamal LNG project in which Chinese firm CNPC bought a 20% stake, which China considers increasing soon to 29.9% via its Silk Road fund. Still Chinese banks have not yet reached final agreement with Novatek to provide loans for the project. Not everybody in Russia is enthusiastic about loans from China. The head of Lukoil, Vagit Alekperov, for example, explained that due to the conditions in which the money would be provided, Chinese bank credits are “among the most expensive in the world.”<sup>105</sup> Generally, Chinese companies and banks, in particular those with subsidiaries in the U.S., were careful not to violate the sanctions regime against Russia. One of the top managers of VTB bank, in

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<sup>101</sup> M. Papchenkova, “Rossiya ubezhdet Kitay podelitsya kapitalom,” *Vedomosti*, 8 July 2015, <http://flynews24.ru/news/328920.html>.

<sup>102</sup> See: “Pryamye investitsii Kitaya v Rossii sokratilis na chetvert,” *Newsru*, 21 July 2015, [www.newsru.com/finance/21jul2015/rucninvest.html](http://www.newsru.com/finance/21jul2015/rucninvest.html).

<sup>103</sup> See: for example, documents signed in September 2015 after the high-level visit of President Putin to China on 3 September 2015, <http://kremlin.ru/supplement/5009>.

<sup>104</sup> For more analysis, see: V. Milov, *Russia’s New Energy Alliances: Mythology versus Reality*, *Russie. Nei.Visions*, no. 86, July 2015, [www.ifri.org/sites/default/files/atoms/files/ifri\\_rnv\\_86-eng\\_milov\\_energy\\_june\\_2015.pdf](http://www.ifri.org/sites/default/files/atoms/files/ifri_rnv_86-eng_milov_energy_june_2015.pdf).

<sup>105</sup> I. Ryabova, “Glava Lukoila nazval kitayskiye kredity samymi dorigimi v mire,” *Slon*, 7 September 2015, <https://slon.ru/posts/56078>.

dealing with Chinese partners, complained about their cautious approach aimed at respecting the sanctions against Russia.<sup>106</sup> Hence, Russian businesses discovered that pivoting to China cannot replace Western investments and that there are few financial opportunities to circumvent the sanctions via Asia.

Afflicted by the sectoral sanctions, Russian banks, energy companies and defence factories had no other option than to slash operational costs and investments. Sberbank put up for sale its subsidiary in Slovakia and Hungary. VTB and Sberbank also carried out personnel cuts in its branches across Europe. More personnel reductions were approved inside Russia. According to released data, layoffs among Russia's 30 biggest banks were eight times higher in the first half of 2015 than in 2014.<sup>107</sup> Gazprom trimmed its investment programme by 40% in 2015, whereas Lukoil listed for sale gas stations in Hungary, Czech Republic and Slovakia. Russia's producer of battle tanks, Uralvagonzavod, has sent up to 7,000 workers on a "forced vacation" for several weeks, while Rostec announced plans to halve its managerial staff in the next two years.<sup>108</sup>

However, Russia's government and major companies hit by the sanctions went beyond cutbacks. Similar to the agricultural and banking sectors, the authorities supported import-replacement programmes in the defence industry and energy sector. So far, the weaker rouble and import substitution drive by the government has changed little, as Russia's industrial output between January and July 2015 declined by 3%.

The military-defence complex developed an import replacement programme for NATO and EU parts and equipment until 2020, which will be financed to a great

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<sup>106</sup> See: V. Gordeev, "VTB pozhalovalsya na 'tshchatelnoye' soblyudenie bankami Kitaya zapadnykh sanktsiy," *RBK*, 5 September 2015, <http://top.rbc.ru/politics/05/09/2015/55ea54fd9a7947a96119c12d>.

<sup>107</sup> Yu. Polyakova, "Chislo uvolneniy v krupnykh rossiyskikh bankakh vyroslo v vosem raz," *RBK*, 25 August 2015, <http://top.rbc.ru/finances/25/08/2015/55db20a79a7947f938d7cdd4>.

<sup>108</sup> "40,000 Managers to Lose Jobs at Russia's Rostec Defence Holding," *The Moscow Times*, 6 April 2015, [www.themoscowtimes.com/business/article/40000-managers-to-lose-jobs-at-russias-rostec-defence-holding/518703.html](http://www.themoscowtimes.com/business/article/40000-managers-to-lose-jobs-at-russias-rostec-defence-holding/518703.html); A. Tomin, "Do 7 tys rabotnikov 'Uralvagonzavoda' otpravlyayut v vynuzhdennyy otpusk," *MK*, 9 February 2015, [www.mk.ru/economics/2015/02/09/do-7-tys-rabotnikov-uralvagonzavoda-otpravlyayut-v-vynuzhdennyy-otpusk.html](http://www.mk.ru/economics/2015/02/09/do-7-tys-rabotnikov-uralvagonzavoda-otpravlyayut-v-vynuzhdennyy-otpusk.html).

extent (up to 80%) by the government. Russia's top military officers reported that out of 127 positions planned for import substitution in 2015, only seven were replaced in the first half of 2015.<sup>109</sup> In some cases, import substitution of Western equipment or technologies should be done from scratch, probably pushing the programme into 2025. Meanwhile, the defence industry has been rocked by multiple corruption scandals as the government poured more money into it. In some cases, the government aid was transferred to offshore accounts, paid to companies headed by relatives for bogus services or put on bank accounts as deposits.<sup>110</sup> With little success in combating the phenomena, it can be assumed that systemic corruption will hinder Russia's import replacement plans in the defence industry. Moreover, there are doubts about whether sectors where Russia significantly lags behind West domestic producers can rapidly replace Western analogues. A shortage of qualified personnel is also likely to slow the import-substitution programmes.<sup>111</sup> Hence, the only way to get around the sanctions in the short and medium terms is to import defence components from states that did not join the Western sanctions coalition. Among the potential sources of high-tech substitution, China and India are not in a position to compensate fully for the blocked access to Western parts and equipment. Nevertheless, they can play some role in the modernisation of Russia's military-industrial complex via supplies of machines and other appliances necessary to the production process.

In the energy sector, the government adopted a similar programme. It divides import substitution measures depending on urgency. Therefore, short-term actions aim to produce results in 2016. Mid- and long-term measures are expected to be fulfilled by 2018 and 2020, respectively.<sup>112</sup> It is unfeasible to

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<sup>109</sup> See: "Armiya zamenit rossiyskoy tekhnikoy 800 vidov inostrannogo oruzhiya," *Rossiyskaya Gazeta*, 16 July 2015, [www.rg.ru/2015/07/16/importozamechenie-site-anons.html](http://www.rg.ru/2015/07/16/importozamechenie-site-anons.html).

<sup>110</sup> For more, see: I. Safronov, "Bezorzuhnyye dengi," *Kommersant-Vlast*, 31 August 2015, <http://kommersant.ru/doc/2796116>.

<sup>111</sup> A. Antonova, "Programma importozameshchenia natolknulas na kadrovyy golod," *Vzglyad*, 4 September 2015, [www.vz.ru/economy/2015/9/4/765123.html](http://www.vz.ru/economy/2015/9/4/765123.html).

<sup>112</sup> See: "Importozameshchenie v neftegazovom komplekse Rossii," *op. cit.*

shake off import dependence in the short to mid-term. Import replacement will require significant investment, which is in short supply in Russia. More than that, there are technological limits that Russia has little chance to sidestep alone. For these reasons, the Russian government intends to assist sanctions evasion by allowing parallel import of equipment employed in drilling works.<sup>113</sup> At the same time, Russian companies engage, with mixed results, in grey imports of Western equipment and parts (e.g., through offshore companies and dummy corporations). However, for offshore exploration and extraction (e.g., floating platforms for drilling) equipment is usually custom-made for specific projects and thus the final destination of a delivery is difficult to conceal.<sup>114</sup> In addition, offshore projects often have no alternative but to use Western equipment. Pressured by the sanctions, Russia's conglomerates in the energy sector are searching for alternative partners or have switched the focus of their current exploration activity. For example, in 2015 Rosneft unveiled plans to increase extraction at its developed oil fields.<sup>115</sup> Bearing this in mind, Rosneft acquired from Canadian firm Trican Well Service (which provides oilfield services) 100% of its subsidiary in Russia. Despite revisiting plans for 2015–2017 to drill fewer wells on the shelf (only nine instead of 31), Russian companies have not given up on attempts to jumpstart Arctic projects, too. Rosneft struck a deal with a Chinese oil drilling company to execute works beginning with 2016 in the Magadan-1 and Lisyansky area in the Okhotsk Sea. In another case, Gazprom Neft's sealed a partnership with Vietnamese firm Petrovietnam for exploration of the Dolginskoye offshore Arctic oil field in the Pechora Sea. It remains to be seen whether these attempts will help to overcome the sanctions-related challenges.

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<sup>113</sup> See: "Minenergo predlozhilo vesti paralelnyy import burovogo oborudovaniya," *op. cit.*

<sup>114</sup> E. Chernenko, E. Popov, K. Melnikov, "SShA i ES otrezayut puti obkhoda," *Kommersant*, 30 July 2015, <http://kommersant.ru/doc/2778321>.

<sup>115</sup> "Rosneft' uvelichit dobychu na deystvuyushchikh mestorozhdeniyakh," *Forbes*, 14 August 2015, [www.forbes.ru/news/297029-rosneft-uvlichit-dobychu-na-deistvuyushchikh-mestorozhdeniyakh](http://www.forbes.ru/news/297029-rosneft-uvlichit-dobychu-na-deistvuyushchikh-mestorozhdeniyakh).

## “I Will Survive”

While the picture of the Russian economy suffering under sectoral sanctions is not very encouraging, things are not as bleak for Russia’s president, at least for now. Several ingredients are responsible for Putin’s high public standings despite the sanctions and worsening economic situation. As mentioned above, the president has shielded his inner circle and struggles to minimise the effects of the economic slowdown. But this is only half of the recipe for stability. In times of dwindling resources and when it is necessary to keep society calm, the Russian president has increasingly relied on technologies typical of “informational authoritarian” regimes,<sup>116</sup> namely information manipulation on a massive scale and (overt or hidden) censorship. To paraphrase one liberal Russian politician, the Kremlin strives to compensate for empty fridges (consumption) with louder TV (propaganda).<sup>117</sup> Co-optation and repression are part of the strategy, but rather more as auxiliary targeted means than primary ones.

To whip the media into shape, Russia amended its “Media Law” by downsizing the legal share of foreign ownership from 50% to 20%. The transition must be finalised by February 2017, but some foreign media outlets have already left or are in the process of selling their assets in Russia. Swiss magazine publishing house Edipresse exited the Russian market in July 2015, while German media holding Axel Springer is close to selling its stakes in Russia by the end of 2015. Administrative tools were employed to close down the few independent voices that remained on the regional level. For instance, TV2 from Tomsk, founded in 1990, was taken off the air in January 2015 when a federal broadcasting watchdog refused to extend the transmission contract with the company. In further monopolising the media landscape, the Kremlin has aggressively moved into music and entertainment media with plans to create a patriotically-

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<sup>116</sup> For a definition and detail about how they operate, see: S. Guriev, D. Treisman, *How Modern Dictators Survive: Cooptation, Censorship, Propaganda, and Repression*, Sciences Po Papers, February 2015, <http://econ.sciences-po.fr/sites/default/files/file/guriev/GurievTreismanFeb19.pdf>.

<sup>117</sup> See: B. Vishnevski, “Kholodilnik ne podklyuchayetsya k televizoru,” *Ekho Moskvyy blog*, 14 August 2014, [http://echo.msk.ru/blog/boris\\_vis/1379558-echo](http://echo.msk.ru/blog/boris_vis/1379558-echo).

oriented holding company around Goskontsert, a state-run enterprise dealing with the organisation of concerts and shows. It is expected that the new media behemoth, powered by VTB bank loans, will absorb popular music radio and TV stations in Russia, after which their editorial policy is likely to undergo changes. Jointly with Kremli Media, Goskontsert bid in summer 2015 for control over the most popular music channel in Russia, MUZ-TV.<sup>118</sup>

Online, Kremlin redoubled its efforts to augment control over the internet and turn it rather into an asset than river of opposing views. Legislation was passed in 2014 to compel web services to keep all data collected on Russian users on servers located inside the country. Regulations for using Wi-Fi at hotspots were strengthened as well, requiring service providers to identify users via passport number. Roskomnadzor stepped up repression of online outlets in 2014 and 2015. In the most notable case, the agency blocked in July 2015 the webpage of the Consumer Rights Protection Society after it published a note on the negative legal repercussions for Russian citizens visiting occupied Crimea.<sup>119</sup> While limiting self-expression on the internet, the Kremlin has heavily relied on a “troll army” to attempt to mould its own version of perceptions of the war in Ukraine, Western sanctions, attacks on Russia’s political opposition and polish the Russian president’s reputation. A number of journalistic investigations and former trolls who have gone public revealed connections between these “troll factories” and Kremlin administration, as well as given inside details about state-guided trolling.<sup>120</sup>

This information manipulation has sought to shape what the population believes about Russia and the outside world while buttressing the president’s

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<sup>118</sup> “Patrioticheskiy mediaholding’ natselilsya na ‘Muz-TV,’” Colta, 10 August 2015, [www.colta.ru/news/8183](http://www.colta.ru/news/8183).

<sup>119</sup> See: “OZPP obzhalovalo v sude blokirovku svoego sayta,” OZPP, 8 July 2015, [www.ozpp.ru/news/ozpp-obzhalovalo-v-sude-blokirovku-svoego-sayta.html](http://www.ozpp.ru/news/ozpp-obzhalovalo-v-sude-blokirovku-svoego-sayta.html).

<sup>120</sup> See: “Gorodskoy tipazh: blogger-propagandist,” *Sobaka*, 28 January 2015, [www.sobaka.ru/city/city/32942](http://www.sobaka.ru/city/city/32942); T. Parfitt, “My life as a pro-Putin propagandist in Russia’s secret ‘troll factory,’” *The Telegraph*, 24 June 2015, [www.telegraph.co.uk/news/worldnews/europe/russia/11656043/My-life-as-a-pro-Putin-propagandist-in-Russias-secret-troll-factory.html](http://www.telegraph.co.uk/news/worldnews/europe/russia/11656043/My-life-as-a-pro-Putin-propagandist-in-Russias-secret-troll-factory.html).

reputation as an incorruptible national leader. The main thrust of the propaganda comes via television, which is the most popular source of information in Russia (72% watched it daily in 2014). In 2014, 50% of Russians considered TV to be the most reliable source of information, but a year later, in 2015, some 64% of respondents now qualified TV as an objective tool for getting information.<sup>121</sup> The Kremlin-sponsored media frenzy on the war in Ukraine spurred a jump in the number of hours Russians spent in 2014 in front of their TVs by 2.5%—the first increase in the last 5 years. The most popular programmes in Russia are daily news shows.<sup>122</sup>

Monitoring Russia's public channels' news programmes helps this analysis by identifying several relevant themes and images promoted by the Kremlin.<sup>123</sup> In general, Russian TV strives to depict Europe in decline (e.g., riots by refugees from the Middle East on a Greek island) and an aggressive Ukraine (e.g., an increase in its military budget). Russian TV largely shies away from domestic problems, except those too difficult to conceal (e.g., fires in southern Siberia in summer 2015), successfully solved, at least on paper, by the prime minister (e.g., Medvedev's visit to check on the apple harvest in southern Russia) or issues uncovered by the president and ordered to be dealt with under his supervision (e.g., the construction of the Vostochniy Kosmodrom, the Russian spaceport). This technique is aimed to uphold the "good-tsar-bad-boys" image, translated into contemporary terms as a competent and thoughtful president versus a corrupt and careless bureaucracy. This message sought to elevate the president not only above society but above the entire political class and depict him as one of the untouchables, with the prime minister far below in the hierarchy. At the same time, there is visible militarisation in the news coverage (namely more

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<sup>121</sup> "Televidenie: doverie i funktsii," *Levada Center*, 14 August 2015, [www.levada.ru/14-08-2015/televidenie-doverie-i-funktsii](http://www.levada.ru/14-08-2015/televidenie-doverie-i-funktsii).

<sup>122</sup> K. Boletskaya, "Vpervyye za mnogiye gody zhiteli Rossii stali bolshe smotret televizor," *Vedomosti*, 26 April 2015, [www.vedomosti.ru/technology/articles/2015/04/27/vpervie-zamnogie-godi-zhiteli-rossii-stali-bolshe-smotret-televizor](http://www.vedomosti.ru/technology/articles/2015/04/27/vpervie-zamnogie-godi-zhiteli-rossii-stali-bolshe-smotret-televizor).

<sup>123</sup> Here the author relied on personal monitoring (though not systematic) of Russian television news (ORT, Vesti) through March 2014–August 2015.

news about the military), ranging from testing of new weapons to the opening of a new command centre, and even a tank biathlon championship.

Regarding the sanctions, key themes can be easily identified. In re-directing responsibility for the sanctions, Kremlin blames the West for the war in Ukraine (e.g., for meddling in the internal affairs of Ukraine or encircling Russia with military bases). Accordingly, Russia's actions in Crimea are justified (e.g., defence of Russian speakers, prevention of NATO bases in Crimea) and the sanctions are the West's punishment for Russia's independent foreign policy stance. Often the sanctions as a group are portrayed as a symbol of aggression against Russia. In addition, the sanctions are presented as aiming to weaken Russia and halt its decade-long rise. Regardless of the sanctions, mass media toes the line that Russia is able to stand up to the West and still find powerful friends in Asia. The food embargo, and later the destruction of imported food, is explained away as the West dumping low quality products on the Russian market while retaining the best ones for domestic consumption. Last, but not least, Russian TV has tried to convince the public that the food embargo is more painful for the West than for Russia, which it claims can easily replace the food with alternative imports and domestic production.

The censorship and hectic propaganda that seeks to revive society's old habits has substantially distorted people's perceptions and has nudged them to internalise the Kremlin's narratives. The previous decade of relative stability and growing prosperity paved favourable ground for this.<sup>124</sup> The manipulative nature of the current public view is reflected in opinion polls conducted in Russia. According to Levada-Center 2015 public surveys, 72% of respondents say the annexation of Crimea signals a resumption of Russia's great power policy, while 66% of respondents perceive Western sanctions as an attempt to weaken and humiliate Russia. Some 70% believe Russia should not compromise in order to have the sanctions lifted, and further, that the best ways to react to the sanctions are to build bolder relations with China, India and the Middle

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<sup>124</sup> For more, see interview with Lev Gudkov in *Novaya Gazeta*, 29 August 2015, [www.novayagazeta.ru/politics/69727.html](http://www.novayagazeta.ru/politics/69727.html).

East (42%) and impose counter-measures against the sanctioning states (38%). More importantly, 35% of Russians believe the food embargo harms the West more than Russia, 39% think Russia's counter-measures damage equally strongly the West and Russia, and only 15% consider the food embargo to be more detrimental to Russia.<sup>125</sup>

When asked about President Putin, 49% of Russians think that the restoration of Russia's great power status is his main achievement, 56% say that the president is not fully informed by his officials, 64% (compared to 49% in 2013) say that the president tries to curb the bureaucracy's drive to use national resources for private means, 70% (compared to 49% in 2013) regard as beneficial to the country the concentration of power in President Putin's hands, and 55% (compared to 26% in 2013) would like to see Putin continue as president of Russia after 2018.<sup>126</sup> Thus, Putin has successfully de-linked himself from Russia's economic troubles and corrupt state machinery, though both are actually products of his policies. Were Russia's political and media environment not skewed as it is, public opinion certainly would be more balanced.

However, the perceptions are not static and the gap between the manipulated images and the reality in Russia has widened. This spawns holes in the propaganda firewall. For instance, the number of those who recognise that the Western sanctions have caused serious problems more than doubled from September 2014 (16%) to June 2015 (33%). Those who are not ready to support the costs of Crimea's absorption amounted to 32% in 2015 (compared to 19%

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<sup>125</sup> See: "Rossiyane odobrili kontrtsanktsii," *Levada Center*, 29 June 2015, [www.levada.ru/29-06-2015/rossiyane-odobrili-kontrtsanktsii](http://www.levada.ru/29-06-2015/rossiyane-odobrili-kontrtsanktsii).

<sup>126</sup> See: "Vladimir Putin: doverie, otsenki, otnoshenie," *Levada Center*, 27 March 2015, [www.levada.ru/27-03-2015/vladimir-putin-doverie-otsenki-otnoshenie](http://www.levada.ru/27-03-2015/vladimir-putin-doverie-otsenki-otnoshenie); "Doverie k vlasti i ofitsialnoy statistike," *Levada Center*, 19 August 2015, [www.levada.ru/19-08-2015/doverie-k-vlasti-i-ofitsialnoi-statistike](http://www.levada.ru/19-08-2015/doverie-k-vlasti-i-ofitsialnoi-statistike); "Putin 3.0: kak izmenilos vospriyatie prezidenta za 15 let," *Levada Center*, 27 March 2015, [www.levada.ru/27-03-2015/putin-30-kak-izmenilos-vospriyatie-prezidenta-za-15-let](http://www.levada.ru/27-03-2015/putin-30-kak-izmenilos-vospriyatie-prezidenta-za-15-let); "Rossiyane poverili v sposobnost Vladimira Putina obuzdat korruptsiyu," *Levada Center*, 17 June 2015, [www.levada.ru/17-06-2015/rossiyane-poverili-v-sposobnost-vladimira-putina-obuzdat-korruptsiyu](http://www.levada.ru/17-06-2015/rossiyane-poverili-v-sposobnost-vladimira-putina-obuzdat-korruptsiyu); "Krym i rasshirenie rossiiskikh granits," *Levada Center*, 23 March 2015, [www.levada.ru/23-03-2015/krym-i-rasshirenie-rossiiskikh-granits](http://www.levada.ru/23-03-2015/krym-i-rasshirenie-rossiiskikh-granits).

in March 2014).<sup>127</sup> In a guns-vs-butter contest, the overwhelming majority of Russians believe that budget expenditures should be focused on improving living standards (67%), healthcare (55%), and social protection (52%) while only 12% prioritise defence expenses.<sup>128</sup> If the economic situation further deteriorates and the Kremlin fails to identify new resources to extinguish the crisis, the propaganda will have to be backed by more open repression at home and/or more muscle-flexing abroad. Apparently, the Kremlin strives of late to replace media coverage of Ukraine with Syria, at least for the time being. Whether the Russian airstrikes against rebels in Syria can steal the show for a long time is an open question. Nevertheless, if the Kremlin reverts to a military scenario in Ukraine, the sanctions regimes against Russia could be tightened, adding to the economic turbulence.

### **Costly Connection with Crimea**

Underpinned by strong economic logic (as understood at that time), the Soviet Union's leadership in Moscow took the collective decision to transfer Crimea to the Ukrainian republic in 1954.<sup>129</sup> Six decades later, Kremlin has embarked on the challenging task of plugging the peninsula into the Russian Federation. The Western sanctions and omnipresent corruption in Russia hardly contribute to the accomplishment of this task. To neutralise the effects of the sanctions on Crimea, the Kremlin poured in funds, adopted a preferential economic regime, worked to legitimise local "authorities," attract investors and find new markets for exports. Moscow also struggled to bypass the Western sanctions, aiming

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<sup>127</sup> See: "Rossiyane odobrili kontrtsanktsii," *op. cit.*; "Krym i rasshirenie rossiyskikh granits," *op. cit.*

<sup>128</sup> "Priorityty byudzhetykh raskhodov gosudarstva," *Levada Center*, 2 June 2015, [www.levada.ru/02-06-2015/priorityty-byudzhetykh-raskhodov-gosudarstva](http://www.levada.ru/02-06-2015/priorityty-byudzhetykh-raskhodov-gosudarstva).

<sup>129</sup> For more analysis on the decision to transfer Crimea and the drivers behind it based on related documents published in 1992, see: G. Sasse, *The Crimea Question Identity, Transition, and Conflict*, Harvard University Press, Cambridge, 2007, pp. 107–126.

to acquire the high-tech products necessary for infrastructure projects on the peninsula.

Russia spent \$3 billion on Crimea in 2014, with another \$2.2 billion earmarked for 2015. With the current level of federal support comprising close to 80% of the local budget in 2014, Crimea is catching up in terms of the heavily subsidised republics of the North Caucasus.<sup>130</sup> Overall, according to Russia's authorities, by 2020 nearly \$14 billion could be allocated by the government to Crimea to upgrade infrastructure and build gas, electricity, and road links with the Russian mainland.<sup>131</sup> With potentially \$30 billion invested by 2020<sup>132</sup> in modernisation of Russia's Black Sea Fleet (which is mainly based on the peninsula), the absorption of Crimea might turn it into another Sochi-like wasteful mega project. There are signs confirming this gloomy prediction.

In addition to the funds allocated, Moscow decided to leave value-added taxes collected in Crimea to the local budget, adding 4% to the peninsula's revenues in 2014. But, as appetite increases during a meal, the Crimean "authorities" asked Moscow in July 2015 for a \$3.5 billion credit to fulfil public obligations.<sup>133</sup> Although the local "authorities" asked for more, they delivered less than expected in Moscow. Crimea was rocked by numerous corruption scandals and arrests. Russia's specialised agencies uncovered schemes of massive misappropriation of funds in Crimea. According to Russia's own statistics, as of July 2015, 48 local "officials" are under investigation on corruption charges and eight members of Crimea's or

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<sup>130</sup> D. Suleymanov, "Krym stal odnim iz samykh dorogikh regionov dlya federalnoy kazny," *Vedomosti*, 18 June 2015, [www.vedomosti.ru/newspaper/articles/2015/06/18/596848-vsem-dorogoi-krim?from=newsletter-editor-choice&utm\\_source=newsletter&utm\\_medium=content&utm\\_campaign=editor-choice&utm\\_term=news14](http://www.vedomosti.ru/newspaper/articles/2015/06/18/596848-vsem-dorogoi-krim?from=newsletter-editor-choice&utm_source=newsletter&utm_medium=content&utm_campaign=editor-choice&utm_term=news14).

<sup>131</sup> "Russia's federal budget to spend \$2.2 billion on Crimea's modernization in 2015," *Tass*, 18 April 2015, <http://tass.ru/en/russia/790315>.

<sup>132</sup> L. Alexandrova, "Russia determined to put more muscle into Black Sea Fleet over next six years," *Tass*, 15 May 2014, <http://tass.ru/en/opinions/763279>.

<sup>133</sup> "Krym prosit kredit na pokrytie 4-milliardnogo defitsita byudzheta," *Tsentr zhurnalistitskikh rassledovaniy*, 8 July 2015, <http://investigator.org.ua/news/158648>.

Sevastopol's "government" have lost their job.<sup>134</sup> In one case, Russia's Investigation Committee discovered that the costs for traffic management projects in Crimea in 2014 were inflated by three times.<sup>135</sup> This might be the tip of the iceberg, as officials from the mainland are likely to be part of schemes to divert public money to private pockets, and hence, decisions to establish a government commission on the socio-economic development of Crimea and Sevastopol or to staff deputy ministers in Crimea's "executive" body with federal officials are unlikely to be a game-changer. This move will change the circuit of spoils from corruption but not its scale. Local "officials" in Crimea complain that they are being sidelined by outsiders from Moscow or neighbouring Krasnodar Krai.

Although Russia's top officials recognise publically the dangers of rampant corruption in Crimea, it is a systemic feature of the Russian state and finds fertile ground in Crimea. More than that, the corruption and lack of rule of law in Russia are responsible for the dire economic situation in Crimea. Close to 30% of Crimea's exports were oriented to Russia. After annexation, Crimea's exports to Russia became de facto intra-state trade exchanges. While, there were hopes that the Russian market would offset partially the peninsula's lost access to the EU, apparently it has not turned as expected in some sectors (e.g., agriculture, fisheries). Privately, Crimean business people complain about harassment from local authorities in neighbouring Krasnodar Krai who often physically prevent exports from Crimea (e.g., traffic police stop vehicles with fruit) from going farther to Moscow or Saint Petersburg.<sup>136</sup> Whereas, Crimea's "return to home" was welcomed symbolically, neighbouring regions with similar trade profiles (e.g. agriculture, fish industry) do not want to compete with Crimea for the large Russian urban markets. It seems that the boost in Russia's patriotism over the annexation of Crimea ends when the money starts talking.

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<sup>134</sup> For more, see: J. Ulianova, "Chekharda v Krymu: pochemu ministry ukhodyat i popadayut pod sledstviye," *RBK*, 29 July 2015, <http://top.rbc.ru/politics/29/06/2015/559134619a79474542c789f0>.

<sup>135</sup> See: T. Pashkova, "SK zavel delo o prevyshenii raskhodov na dorogi v Krymu v tri raza," *Slon*, 21 August 2015, <https://slon.ru/posts/55421>.

<sup>136</sup> Author's interview with a Russian investigative reporter, 2015.

Despite many setbacks, Russia has tried to de-isolate Crimea by seeking recognition of the local “authorities,” keeping alive foreign sea trade through Crimea’s ports, inviting foreign investors, increasing the capacity of the ferry service across the Kerch Strait, and investing in critical infrastructure. This often has been done by violating or circumventing the sanctions. By including Crimean “officials” in overseas delegations (e.g., the head of Crimea, Sergei Aksyonov, visited Delhi in December 2014) or by inviting foreign lawmakers to Crimea (e.g., French MPs in July 2015), Moscow intends to create the appearance of international recognition of local institutions in Crimea. Russia also has turned Crimea into a Free Economic Zone for 25 years and advertises Crimea as a destination for investments. Although the “officials” in Simferopol boasted of major investments to come to Crimea from China (e.g., tobacco firms), Turkey (livestock industry), France (a winery), India (pharmaceuticals) and South Korea (car industry), to date such declarations cannot be confirmed from credible sources or developments on the ground. Information about foreign investors in Crimea is most likely aimed to feed the appearance of de facto recognition of the change of the peninsula’s status.

Russia has maintained, even if it is limited, foreign traffic via Crimea’s ports. Despite the sanctions, from March 2014 to July 2015, 216 civilian ships have called to ports in Crimea. After Russian-flagged vessels (101), ships from Turkey (52) and Greece (28) most often entered Crimean ports.<sup>137</sup> Among the Greek vessels were eight ferries brought in to help Russia increase its transportation capacity in the Kerch Strait. Some of the Turkish ships were also engaged in transportation of passengers and cargo to Crimea. Russia also allegedly used sea access in Crimea to pull off murky schemes involving intermediaries, such as exports of grain from Crimea to Cyprus and Saudi Arabia. To revive cruise tourism, Russia has struggled to launch a Sochi-Yalta-Sevastopol route. In 2014, Moscow strived to

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<sup>137</sup> Data collected via automatic identification system (installed on ships) signals and other computer software helping to localise vessel movement. Vessel distribution by country was assigned according to ship-owner’s nationality. For more, see: A. Klymenko, O. Korbut, “Blacklist: 105 foreign ships that entered Crimea over period of annexation (Russian and Ukrainian not included);” *BlackSeaNews*, 21 July 2015, [www.blackseanews.net/en/read/102605](http://www.blackseanews.net/en/read/102605).

maintain in word and deed the international status of Simferopol airport. Russian officials inaccurately reported that in July 2014 the International Civil Aviation Organisation (ICAO) had recognised Russia's jurisdiction over Crimea and thus the right to control the airspace over it. However, ICAO quickly rebuffed such claims and reiterated Ukraine's sovereignty over Crimea.<sup>138</sup> The same month, Russian air transport watchdog Rosaviation, despite the ICAO decision not to certify flights to or from Crimea, authorised Chechen company Grozny Avia to operate direct flights from Simferopol to Yerevan, Istanbul and Antalya.<sup>139</sup> The Grozny Avia webpage does not indicate that the company operates flights to Armenia and Turkey. Nevertheless, the Chechen air carrier was able to conduct occasional flights from Simferopol to Istanbul via Anapa (Krasnodar Krai).<sup>140</sup>

In addition to plans to construct a bridge across the Kerch Strait and lay electric cables and a gas pipeline from the Russian mainland to Crimea, Moscow has mulled building electric power plants in Crimea. Currently, depending on consumption, Crimea imports between 70% and 90% of its electricity from Ukraine. To oust Ukraine and that leverage over Crimea, Russia aims to build two power plants on the peninsula. It seems that Russia has agreed with a Western company willing to take on the project and evade the sanctions. Reportedly, Rostec subsidiary Techpromeksport concluded last spring a contract for a joint venture with Siemens and Russia's Power Machines company for the delivery of four gas installations with gas turbines. The contract specifies the destination as Taman in Krasnodar Krai (thus, in the immediate vicinity of the peninsula)

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<sup>138</sup> "International Civil Aviation Organization Does Not Recognise Crimean Air Space as Russian," *StopFake*, 5 July 2014, [www.stopfake.org/en/international-civil-aviation-organization-does-not-recognise-crimean-air-space-as-russian](http://www.stopfake.org/en/international-civil-aviation-organization-does-not-recognise-crimean-air-space-as-russian).

<sup>139</sup> "Chechen Airline Gets Permission for Flights From Simferopol to Istanbul," *The Moscow Times*, 29 July 2014, [www.themoscowtimes.com/news/article/chechen-airline-gets-permission-for-flights-from-simferopol-to-istanbul/504271.html](http://www.themoscowtimes.com/news/article/chechen-airline-gets-permission-for-flights-from-simferopol-to-istanbul/504271.html).

<sup>140</sup> "SBU opens case on flights of Grozny Avia planes to Crimea," *Interfax-Ukraine*, 8 May 2015, <http://en.interfax.com.ua/news/general/264480.html>.

as the sanctions prohibit supplies of this type of equipment to Crimea.<sup>141</sup> Both sides acknowledge that such a contract has been signed. However, while the contracting parties appear to respect the formalities, the chances are high that the contract serves as a smokescreen for the later shipment of the gas installations to Crimea, which would then be a violation of the sanctions.

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<sup>141</sup> See: A. Fadeeva, D. Simakov, "Siemens postavit turbiny dlya krymskikh elektrostantsiy," *Vedomosti*, 30 June 2015, [www.vedomosti.ru/business/articles/2015/06/30/598584-tehno-promeksport-nasel-turbini-dlya-krimskih-elektrostantsii](http://www.vedomosti.ru/business/articles/2015/06/30/598584-tehno-promeksport-nasel-turbini-dlya-krimskih-elektrostantsii).



# BUSTING MYTHS AND LEARNING LESSONS

A year and half since sanctions were imposed on Russia is long enough to evaluate their preliminary effectiveness, to judge how Russia has reacted thus far to them and to draw first lessons for the West with the aim to streamline the approach towards both the sanctions and Russia.

Critics often claim that the sanctions have made President Putin and his political regime stronger domestically, without changing much of Russia's foreign policy, in particular towards Ukraine. But as this report demonstrates, such a stance misreads the sanctions' design and ignores the sanctions' restraining effect on the exercise of Russia's power in Ukraine. Moreover, critics underplay the political dynamics in Russia before 2014.

The current cycle of political power consolidation in Russia goes back to the presidential elections in 2012 when, at that time, Prime Minister Putin faced serious public discontent over his candidacy. After he bulldozed his way to election, President Putin, under a roof of traditional values, worked to punish emerging non-systemic opposition, coalesce the elites and emerge as a national leader. The annexation of Crimea was part of this authoritarian "success story." The sanctions enacted on Russia in the aftermath of Crimea and the war in Donbass underscored the political dynamics in Russia and added some undertones rather than triggered them. With or without the sanctions, Kremlin's power concentration would have proceeded unabated, and hence, the sanctions' responsibility for more pronounced authoritarian trends in Russia is overblown.

More importantly, the sanctions are not about regime change in Russia but are aimed at raising domestic constraints on an increasingly personalist authoritarian regime. Putin's efforts to reward his inner circle and hold the reins on Russia prove

he has taken the challenge seriously, while his compensatory measures have generated additional costs to the Russian budget. The shrinking economic pie has boosted the extractive nature of the economic institutions in Russia (e.g., the inner circle's grab for assets and flows of budgetary funds).<sup>142</sup> The declining quality of living has been covered up by information manipulation. These factors combined have harmed Russia's social fabric, with dire long-term consequences. As extractive institutions leave no chance for economic opportunities outside a small group, the most active and innovative social constituencies have been pushed out of the country (e.g., ecological activist Yevghenia Chirikova, economist Konstantin Sonin). Massive propaganda, meanwhile, has instilled lopsided perceptions about the world around Russia, which sooner or later will crumble, sending shock waves across the political system. Thus, President Putin has consolidated his public standing but it has extricated from him a high price, as the power cementing has taken place in a much shakier and more volatile economic environment. If there were to be regime change in Russia (though it looks improbable in the short to mid-term), it will take place not primarily because of the sanctions but because of decisions made by the Kremlin, including those related to how it has chosen to deal with the sanctions.

Last but not least, the sanctions are not about democracy promotion in Russia, rather they aim to give a chance for a deeper democracy to take root and thrive in Ukraine, in tune with the popular demands expressed in 2013–2014. The sanctions do not seek to weaken Russia per se. Their reversibility shows that the main goal is to help Ukrainian statehood survive in the context of Russia's military aggression. As the West has ruled out direct use of lethal means to

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<sup>142</sup> Economic institutions are labelled extractive “because such institutions are designed to extract incomes and wealth from one subset of society to benefit a different subset.” Alternatively, “inclusive economic institutions ... are those that allow and encourage participation by the great mass of people in economic activities that make best use of their talents and skills and that enable individuals to make the choices they wish. To be inclusive, economic institutions must feature secure private property, an unbiased system of law, and a provision of public services that provides a level playing field in which people can exchange and contract; it also must permit the entry of new businesses and allow people to choose their careers.” See: D. Acemoglu, J. Robinson, *Why Nations Fail: The Origins of Power, Prosperity, and Poverty*, Crown Business, New York, 2012, pp. 70–95.

protect Ukraine, the sanctions represent a fairly efficient and low-cost tool to shelter Ukraine and dissuade Russia. If the West had stayed away from the issue in 2014, most probably it would now have had to devise a more expensive and risky answer to Russia's aggression, which by that time may have threatened Ukraine's neighbours, too. Critics argue that despite the sanctions Russia has not vacated Crimea and instead has put troops and sent munitions to Donbass, while Ukraine is still poorly governed. But this is only part of the story. The sanctions escalate the price Russia pays for Crimea's annexation. With the sanctions in place, Russia is preoccupied with how to keep the conflict burning and less about another major military thrust in Ukraine (which by now would result in higher casualties on the Russian side). Probably the most essential aspect often neglected is that the sanctions bought the time needed to fill the political and military power vacuum in Ukraine (e.g., giving time for presidential and parliamentary elections as well as military mobilisation). Seen in this perspective, without the sanctions debate there would be today not a discussion about imperfect governance in Ukraine but about the absence of governance in a worst-case scenario.

Bearing in mind the damage caused by the sanctions and the adaptation tactics on the part of Russia, there are several lessons to be learnt and corrections to be made in the sanctions regime and in the general approach towards Russia.

The EU should address the breach in political-diplomatic sanctions by EU Member States. By challenging sanctions at this level, Russia has tried to build an anti-sanction coalition within the EU. Greece's hidden and open blocking tactics in 2015 speak volumes in this regard. While it was not enough to thwart the sanctions, it required additional efforts at the EU level to hold the line. The debate on the extension of the sectoral sanctions is likely to resurface in the EU in late 2015. Given Russia's propensity to influence such conversations, the consensus-building process on maintaining the sanctions should not be ignored. This will represent ultimately a litmus tests of whether Russia's previously winning divide-and-conquer approach towards the EU is still valid. To annihilate these tactics, the EU should continue to provide direct and indirect support to EU Member States in order to mitigate the effects of such counter-measures as the food embargo

(e.g., aid to the dairy industry and animal producers) as well as to diversify sources and routes of energy imports. In addition, it is important to underscore that lifting sanctions might not have the desired trade effect (i.e., an increase in exports to Russia) as there are structural problems that have squeezed the Russian market and, consequently, demand. For example, despite its economic opening to Beijing, Russia's imports from China declined by 36% in the first seven months of 2015.<sup>143</sup>

Although consensus is important, the full implementation of the sanctions regime is equally essential to the credibility of the sanctioning states vis-à-vis the target. The maintenance of sanctions accompanied by little interest in enforcing them sends the wrong signal to a sanctioned state. In Russia's case it would mean a more intrusive mechanism to monitor evasion tactics and timely close loopholes in the sanctions regime. While specialised U.S. institutions (e.g., Office of Foreign Assets Control at the U.S. Treasury Department, coordinator for sanctions policy at the U.S. State Department) have rich experience enforcing complex sanctions regimes, the EU often lacks the human resources (e.g., the Sanctions Division within the European External Action Service is still understaffed) and does not have enough experience (though the sanctions on Iran have served as an invaluable learning exercise) on the implementation of multi-layered sanctions. While the US has on several occasions corrected provisions of the sanctions to close legal gaps or extend the blacklist to entities or individuals (EU Member State citizens included) who have helped Russia to avoid the sanctions, the EU has not been as proactive in this regard.<sup>144</sup> Noteworthy, in July 2015, the U.S. for the first time with Russia put on its blacklist a family member of a targeted individual (in this case, Roman Rotenberg, son of Boris Rotenberg) who the U.S. deems to have assisted his relatives to evade the sanctions.<sup>145</sup>

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<sup>143</sup> "Kitay za god sokratil investitsii v rossiyskuyu ekonomiku na 20%," *Newsru*, 21 August 2015, [http://palm.newsru.com/finance/21aug2015/china\\_russia.html](http://palm.newsru.com/finance/21aug2015/china_russia.html).

<sup>144</sup> See: "Sanctions against Russia: Fancy Footwork," *The Economist*, 14 February 2015, [www.economist.com/news/business/21643122-how-businesses-linked-blacklisted-oligarchs-avoid-western-sanctions-fancy-footwork](http://www.economist.com/news/business/21643122-how-businesses-linked-blacklisted-oligarchs-avoid-western-sanctions-fancy-footwork).

<sup>145</sup> See: "Ukraine-related Designations," US Department of the Treasury, 30 July 2015, [www.treasury.gov/resource-center/sanctions/OFAC-Enforcement/Pages/20150730.aspx](http://www.treasury.gov/resource-center/sanctions/OFAC-Enforcement/Pages/20150730.aspx).

The EU's sanctions regime on Russia requires several upgrades. The bloc should consider extending sanctions to individuals (family members included) and Russian companies if they have been involved in covering up activities related to evading EU sanctions on Russia. But this effort should not be limited to individuals or legal persons from Russia. To deter European companies from breaking the sanctions on Russia, it is worthwhile to explore at the EU level various penalties and mechanisms to punish such behaviour. So far, the discussions inside the EU have not gone beyond an exchange of information on national systems to punish sanction violators. Nevertheless, because national punishment mechanisms often fail, the U.S. must play the role of ultimate enforcer (e.g., a U.S. fine against BNP for violating the sanctions on Iran). The EU needs to redress this state of affairs in order to be perceived as a credible foreign-policy actor.

On the institutional level, the EEAS prepares individual sanctions whereas the EU Commission (e.g., DG Trade, DG Energy, Service for Foreign Policy Instruments and others) deals with sectoral sanctions and those related to Crimea. Monitoring their implementation falls to the Working Party of Foreign Relations Counsellors (RELEX), composed of representatives of EU Member States with the participation of the EEAS and EU Commission (as attendees). Because the sanctions regime on Russia is a rather complex cross-sectoral issue, the EU should consider an increase in its capacity to enforce the sanctions regime on Russia by assembling a special group of experts on the matter (using in part the experience of the sanctions on Iran). The Sanctions Division at EEAS is responsible for more than 30 EU sanctions regimes<sup>146</sup> and RELEX has to cover a wide foreign policy agenda, so such a group would help the EU to deepen its focus on restrictive measures on Russia and to react more promptly. Much closer interaction between the U.S. coordinator on sanctions policy and EEAS would also help to fully enforce the sanctions regime on Russia.

While the sanctions are reversible, it is important to know under which conditions they can be softened or removed. It is highly unlikely that the U.S. will

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<sup>146</sup> "Restrictive measures (sanctions) in force," *EEAS*, 19 March 2015, [http://eeas.europa.eu/cfsp/sanctions/docs/measures\\_en.pdf](http://eeas.europa.eu/cfsp/sanctions/docs/measures_en.pdf).

backtrack on conditionality. The EU might be more vulnerable in this case. If the extension of individual sanctions to March 2016 was smoothly approved, then sectoral sanctions are likely to provoke a livelier debate within the EU. For the EU, it is fundamentally important to stick to inbuilt criteria, namely implementation of the Minsk accords (for sectoral sanctions). Should the EU relax the sanctions before the criteria are fully met, the power-driven ruling elite in Russia will interpret it as a sign of weakness on the part of the EU, increasing the chances for re-escalation of the conflict in Ukraine. Thus, instead of downsizing the EU's conflict-management costs, prematurely eliminating the sanctions risks increasing them sharply. Besides, respecting criteria for lifting the sanctions (partially or fully), the West should be ready to introduce new sanctions if the situation in Ukraine demands it (e.g., there is a renewed offensive). This should undercut Russia's time-to-act advantage to escalate then rapidly de-escalate military actions to counter the threat of new sanctions.

The sanctions will remain an important element of the Western strategy on Russia. However, the sanctions are not a universal answer and should be backed up by other instruments. In addition to the restrictive measures on Russia, substantial and long-term assistance to modernise Ukraine's economy and reform its security sector should be instituted. Other members of the Eastern Partnership pressured economically and militarily by Russia or otherwise deserve additional EU focus, too. Commitments to strengthen the security of NATO member states neighbouring Russia should be carried out, and as the situation evolves, a new set of actions will be needed. A creative approach to reach out to the Russian populace, which is misinformed about the West and kept in the dark about the country's domestic problems, should also be part of the strategy. Finally, the door for engagement with Russia should remain open. But it should be principled, so that the door for spheres-of-influence-type deals Russia yearns for is hermetically closed.

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