THE CURRENT ECONOMIC STATE OF PLAY IN RUSSIA

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In December 2014, the Russian economy entered a crisis state that may be described as a perfect storm.[1] This conundrum has at least three major causes: state and crony capitalism, the sharp fall in the price of oil and Western financial sanctions. Even if the real panic ended in January 2015, all economic data look poor. The natural outcome is a sharp contraction in the Russian economy this year.

The Russian government is reacting to the crisis, but not very well. Officials will not abandon the current policy framework, even though it offers few effective options. The government has adopted an anti-crisis program, but its measures are of limited consequence and crisis management is not very apt. Therefore, government policies are not likely to resolve the crisis. There is a chance to steer Russia away from the path toward economic disaster, but the kremlin is likely to balk at the necessary measures.

After exploring these problems, this paper considers what the US and European governments can and should do in this situation. How can they act, and what impact are their alternative actions likely to have? The overall conclusion is that the current financial sanctions have great effect, and that it is difficult to see any major avenues of new cooperation between Russia and the West until its military aggression has ceased.

The Current State of the Russian Economy

In the 1990s, Russia went through a difficult transition. Officially, GDP fell by half, which is probably an exaggeration, but the output fall was certainly substantial. Still, a transformation to a market economy took place. Prices and markets were liberalized, and two-thirds of the economy was privatized. The financial crash of 1998 cleansed the economy of subsidies and forced the government to balance the budget.[2]

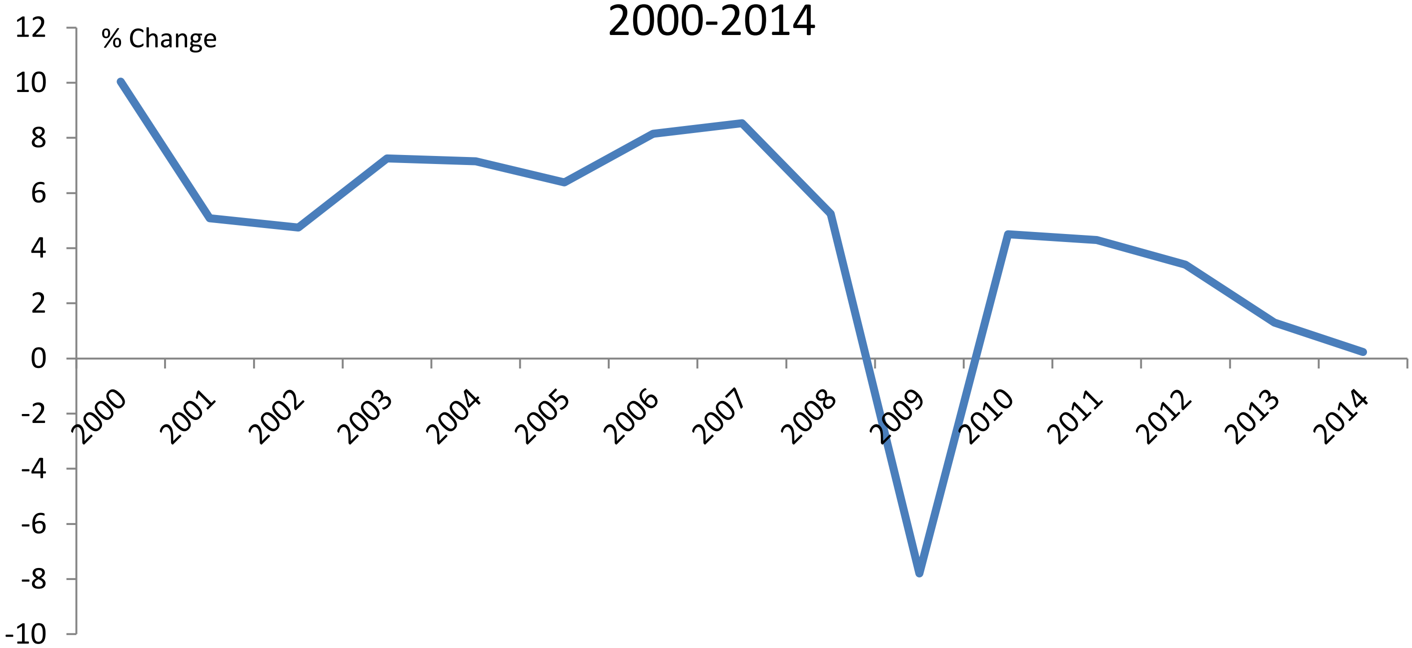
The decade of 1999–2008 offered average annual economic growth of no less than 7 percent.[3] In US dollar terms, the GDP surged from merely $200 billion in 1999 to $1.9 trillion in 2008. Three major forces brought about this success. The first was the economic transformation of the 1990s. The 1998 crash brought about major cuts in public expenditures, both leveling the playing field and bringing the budget into surplus from 2000 onward. Second, after the long depression, Russia had plenty of free capacity: human capital, raw materials and factories. Third, from 2003 until 2008 world oil prices rose sharply, but then they leveled off. The Russian public, however, tends to relate these economic successes to President Vladimir Putin's coming to power in 2000, although that happened almost a year after the strong growth had started. Therefore, domestic popular understanding of what caused the high growth is distorted. This period was the best time ever for Russia's economy, and the conditions that caused it are unlikely to return.

Since 2008, Russian GDP has lingered around $2 trillion. In response to the global liquidity freeze that ensued in the wake of the Lehman Brothers bankruptcy in September 2008, Russia in 2009 pursued the largest fiscal stimulus package of all G-20 countries, amounting to $200 billion, or 10 percent of GDP. Even so it experienced the largest decline in output of any G-20 country, with the economy contracting by 7.8 percent. The reasons for this were that Russia carried out a gradual devaluation that effectively bailed out the big state corporations and the big private businessmen, and also that state subsidies were directed to bailing out these two groups. As a consequence, the "big bad" enterprises crowded out promising new enterprises, in contrast to 1998, when the state had no means to bail out poorly performing corporations and a healthy period of creative destruction ensued. The Russian economy has barely recovered to its level of 2008, and during the two last years growth was only around 1 percent (Figure 1). As of January 2015, the economy has started to contract.

The most fundamental problem with the Russian economy under Putin is systemic: the ever-growing domination of state and crony capitalism.[4] Senior state officials claim that the private share of produced GDP has fallen from 70 percent in 2003 to 50 percent at present. Large state corporations with ample state funding purchase large private companies, after which the former owners tend to retire and emigrate. A case in point is state-owned Rosneft's purchase of the well-managed private corporation TNK-BP for $55 billion in 2012.[5] Today, value-destructing Rosneft has a total market capitalization that less than that of TNK-BP alone. Rosneft and the other state energy giant, Gazprom, appear particularly mismanaged, but they buy other companies although their own production declines. The banking sector has seen a parallel trend, with state banks now holding 60 percent of all banking assets. At the same time, well-connected businessmen receive favorable state orders, especially from Gazprom, which has made a few cronies very wealthy. (Leading opposition politician Boris Nemtsov, who was assassinated in Moscow in February, wrote one of his most popular critical booklets about Putin and Gazprom.[6]) As a consequence of such increasing top-level corruption and the lack of significant structural reforms since 2003, Russia's potential growth has gradually declined to 1 percent.

For 19 years, Moscow endeavored to pursue global economic integration and become a member of the World Trade Organization (WTO). But by the time it acceded to the WTO in August 2012, Russia had, contrary to its stated aims, turned more protectionist. Since June 2009, Putin has focused on developing the Eurasian Economic Union (EEU) of

Figure 1: Russia's Annual GDP Growth
2000-2014



Source: IMF, WEO October 2014

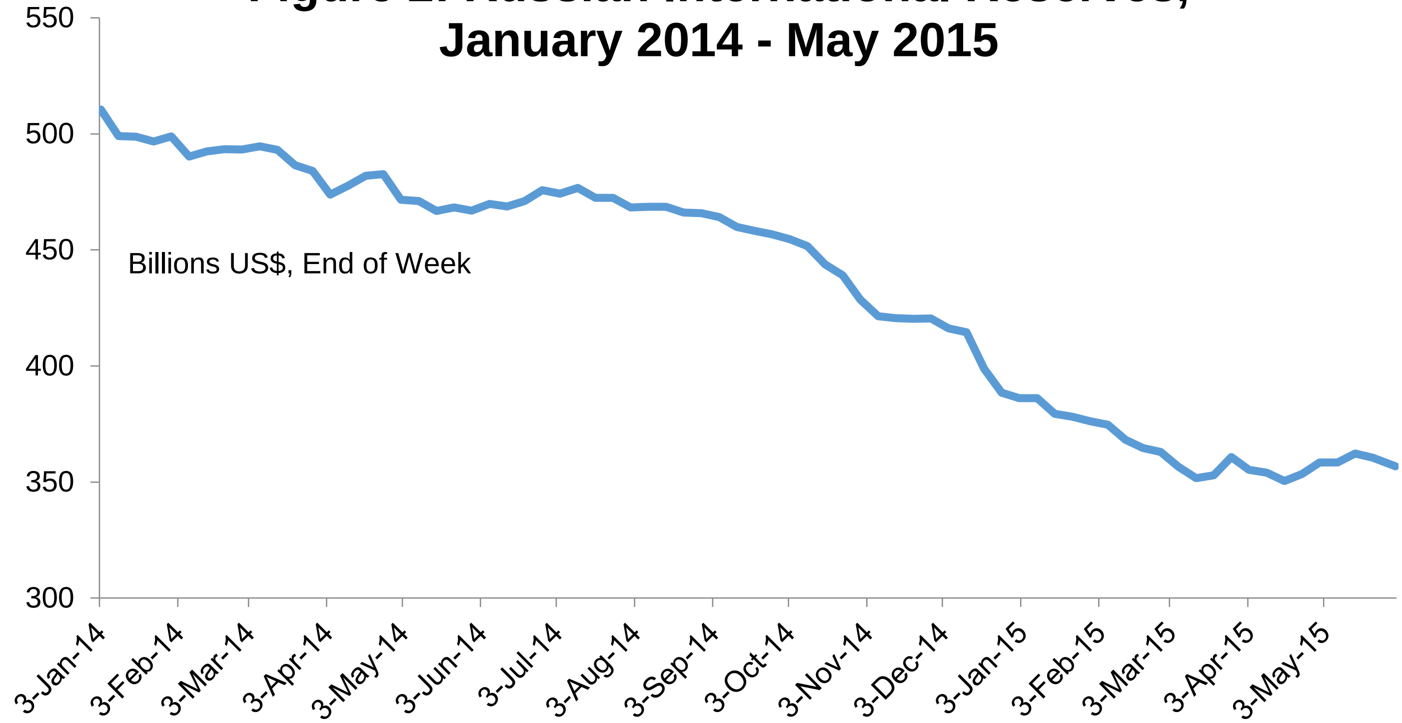
Russia, Belarus and Kazakhstan. In September 2013, Russia persuaded Armenia to join, and Kyrgyzstan is going down the same route. In May 2014, the EEU adopted its full treaty. For a trading community, however, the EEU appears poorly designed. Russia is completely dominant, even if the formal rules suggest equal rights and checks and balances. Russia had about twice as high customs tariffs as most other post-Soviet countries, and it has forced the other member countries to approximately double their import tariffs. This has blocked Kazakhstan from WTO membership. The objective for Belarus, Armenia and Kyrgyzstan is to extract substantial bilateral subsidies from Russia as political side payments. In reality, the EEU is neither a customs union nor a free trade area, but it is highly protectionist against its own members. Kazakhstan complains that it cannot sell oil or gas to or through Russia, and old-style Soviet food standards bar food imports into Russia from both Kazakhstan and Belarus. In short, the EEU has tried to maintain Soviet-era trade standards that cannot compete with their modern-day EU equivalents. Yet the Kremlin commitment to the EEU seems unwavering.

The second problem with the Russian economy is exogenous: the falling global price of oil. The common assumption is that the price this year will be around $50 per barrel, half of the average of $100 per barrel last year. Oil and gas, whose prices are linked, are of enormous importance to the Russian economy. The three key numbers are two-thirds of exports, half of state revenues, and one-fifth of GDP. These numbers have held fairly steady in the last four years, 2011–2014, as oil and gas production have been close to stagnant and oil prices had leveled off until they started falling in late 2014. For the last four years, the value of Russia's total exports of merchandise has averaged around $520 billion. If the oil price really falls by half this year, the country would lose export earnings in the order of $170 billion. For the last four years, Russia's imports have averaged $310 billion, meaning that the country maintains a large trade and current account surplus. For many reasons, not least the financial sanctions imposed by the West in response to the standoff over Ukraine, this large surplus is likely to persist.[7] To maintain it in the face of the steep drop in exports, Russia would have to cut its imports by half, to about $150 billion. That will deliver a hard blow to the economy.

The third major problem with the Russian economy is the impact of the Western financial sanctions that has been far greater than anticipated. On July 16, 2014, the United States introduced so-called sectoral sanctions, and the European Union followed suit on July 31, after the shooting down of a Malaysian Airlines jet over rebel-held territory in eastern Ukraine on July 17. The sectoral sanctions focused on finance, defense and energy, but the financial sanctions have turned out to be by far the most important. In effect, Russia has had no access to international funding since July 2014. The reason is the United States' strict financial regulations. After BNP Paribas was forced to pay a fine of nearly $9 billion for having violated other US sanctions in spring 2014, international banks have been afraid to violate these rules. Because the financial sanctions were imposed by presidential executive order and not by law, they can be amended without warning. A bank that finds itself with an asset that has suddenly become sanctioned can be forced to unwind the transaction at great cost. Therefore, the big banks' compliance officers strictly police any sensitive transactions, effectively blocking plenty of transactions that are still legal.

Both state and private corporations in Russia are quickly paying down their foreign debts. State corporations have been forced to do so because of sanctions and declining credit ratings. Private corporations are interested in paying off their foreign debt quickly for many reasons. They widely expect the value of the ruble to fall further, and they want to avoid that currency risk. In many cases they have plenty of foreign liquidity in Russia, and they want to save it abroad while they can. Arguments are often made about dollar liquidity in Russia and vast Russian holdings of currency abroad, but nobody has an interest in returning money to Russia if they can avoid it because money is less safe there given the poor legal system and lack of strong property rights.

Figure 2: Russian International Reserves, January 2014 - May 2015



Source: Central Bank of Russia, International Reserves of the Russian Federation, Available at: http://www.cbr.ru/Eng/hd_base/Default.aspx?PrtId=mrrf_7d

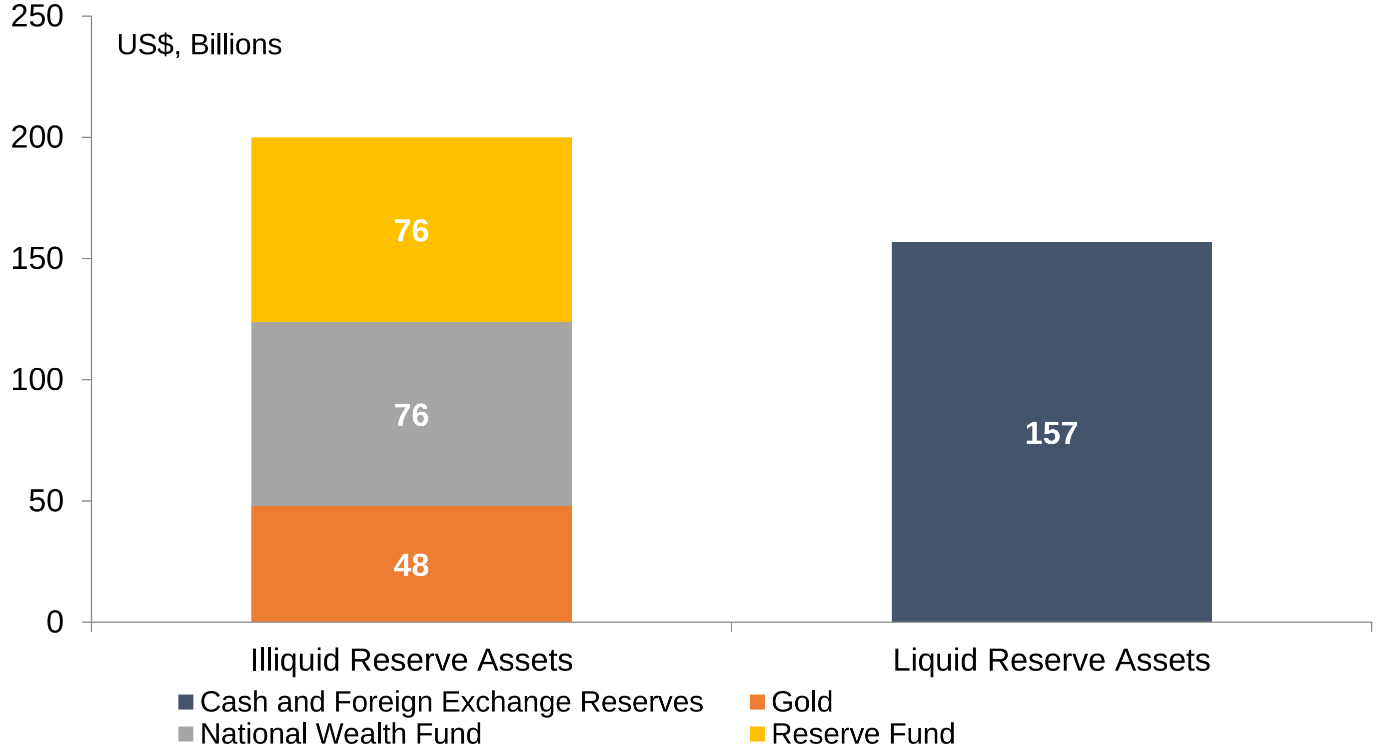
In short, with regard to capital flows, all risks are on the downside.

Russia's official international currency and gold reserves have shrunk quickly. In 2014, they fell from $510 billion to $385 billion. During the first three months of 2015, they shrank by another $29 billion, while April and May saw no net outflows (Figure 2).

It should also be noted Russia's international reserves are in general seriously exaggerated, because they also contain two sovereign wealth funds that are controlled by the finance ministry and spoken for for other purposes. The Reserve Fund of $76 billion on June 1, 2015, is supposed to help finance the budget; two-thirds is currently scheduled to be used up in 2015 and the rest in 2016. The National Wealth Fund of $76 billion on June 1 is likely to be used for infrastructure investments and bank recapitalization. Therefore, the $152 billion in the Reserve Fund and the National Wealth Fund, though they are counted in the totals and are liquid, are not actually available for the Central Bank of Russia to draw on as foreign currency reserves. The IMF allows sovereign wealth funds to be included in currency reserves, but many countries, such as Norway and Kazakhstan, have chose not to do so, and that appears a more appropriate practice.[8] In addition, the central bank holds $48 billion of gold, which is valuable but not fully liquid.

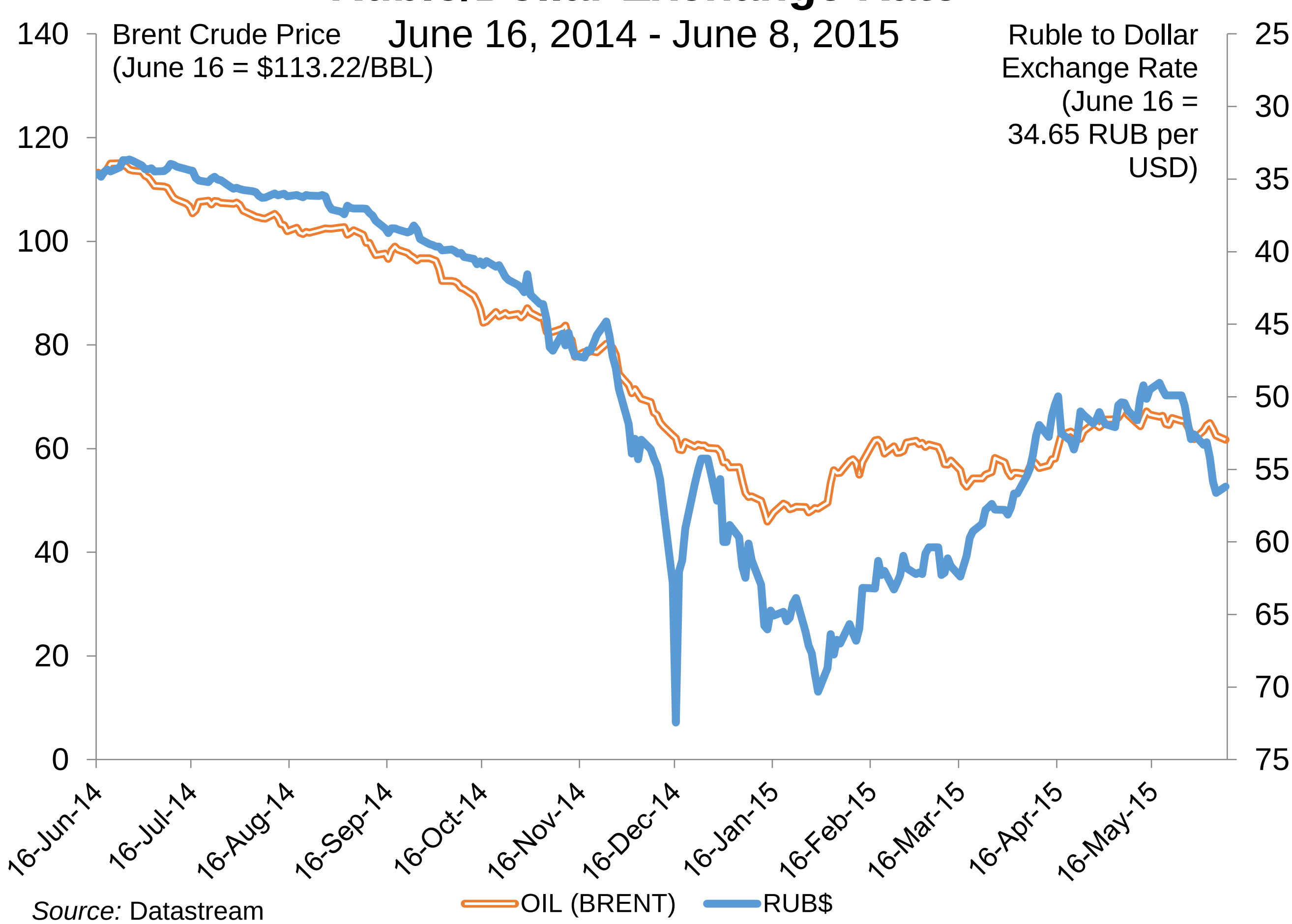
Thus, on June 1, 2015, the central bank had only $157 billion of liquid international reserves (Figure 3, next page). This should be compared with Russia's foreign debt of $570 billion. Usually, foreign debt is compared with GDP, but given that Russia is now facing a nearly complete liquidity freeze, as the whole world did for half a year after the Lehman Brothers bankruptcy in September 2008, the relevant factor is not GDP but liquid reserves. Russia is expected to lose about $100 billion net in international reserves this year. The first quarter saw larger than expected outflows. In April and May, the

Figure 3: Russia's Reserve Assets, June 1, 2015



Sources: Central Bank of Russia
Available at: http://www.cbr.ru/eng/hd_base/?PrtId=mrrf_m

Figure 4: Brent Crude Oil Price vs. Ruble/Dollar Exchange Rate



Source: Datastream

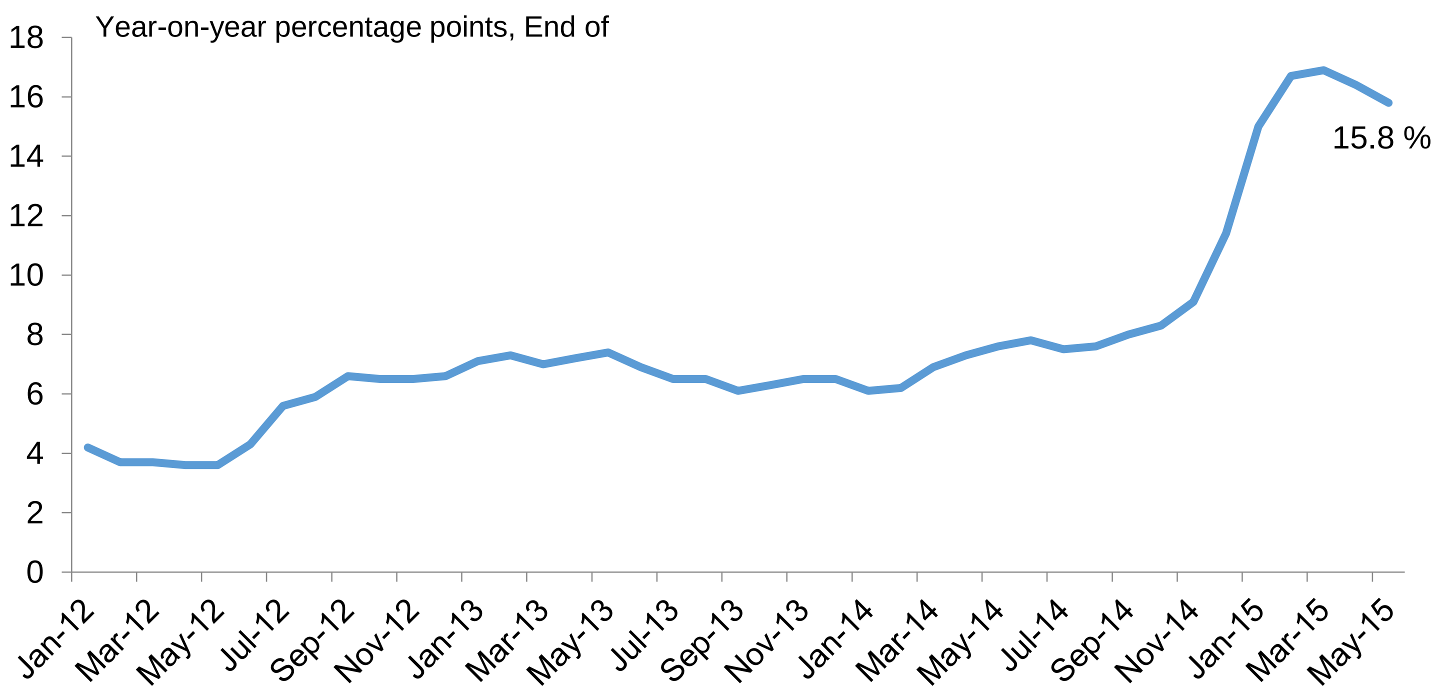
depressed values of Russian stocks, bonds and the ruble itself attracted significant inflows, but they had the character of relief rally and bottom fishing. The capital outflows are likely to catch up again as people and corporations become increasingly afraid of capital controls. Russia is then likely to end up in a liquidity squeeze in late 2015, if there is no major change in any of the three causes of this squeeze.

The combination of falling oil prices and financial sanctions has had a great impact on the ruble exchange rate, which has floated relatively freely since February 2009. The conventional wisdom has been that the ruble-dollar rate and the oil price in dollars follow one another closely. That was true until late November 2014, when the ruble went much lower than the oil price. After four months, the ruble caught up with the oil price that recovered substantially. The cause of the catch up of the ruble was the relief rally and the accompanying capital inflows, but eventually the financial sanctions that limit Russia's available financing and drive the ruble down more than the oil price (Figure 4, previous page).

As a consequence of the sharp fall in the ruble exchange rate, inflation has shot up. In early 2012, it appeared as if Russia's inflation finally had come down to the low single digits, at 4 percent. Then, it rose to around 7 percent, but since the exchange rate started to plunge in November 2014, inflation peaked at16.9 percent on a year-over-year basis in March (Figure 5). It leveled off somewhat to 15.8 percent in May after the oil price and the ruble exchange rate had recovered, but as the ruble exchange rate appears to dip again inflationary pressures may return. The government expects inflation to fall to 12 percent for the year as a whole, but this appears improbable. In December 2014, the central bank "shock-hiked" its benchmark interest rate from 9.5 percent to 17 percent to stop the collapse of the ruble and the ensuing inflation. Soon afterwards the first deputy chair in charge of monetary policy was removed. In 2015, the bank has

Figure 5: Russian Consumer Inflation Rate

January 2012 - May 2015



Source: Bloomberg

cut its benchmark rate three times to 12.5 percent by the end of April, that is, to significantly less than inflation. The rationale was the daring assumption that inflation will fall with shrinking demand.

What does all this amount to? The official GDP forecast of the Russian Ministry of Economic Development for in 2015 is a decline of 3 percent, while the Central Bank foresees a contraction of 4.5–5 percent. The international financial institutions' views are similar. According to their latest forecasts from January, the World Bank and the IMF predicts a decline of 3.8 percent in 2015 at an average Brent oil price of $53 per barrel, and the European Bank for Reconstruction and Development a decline of 5 percent. The Ministry of Economic Development has anticipated an average oil price of $50 per barrel, inflation of 12.2 percent (while it is currently 15.8 percent) and an average exchange rate of 61.5 rubles per dollar (while it is 56 rubles per dollar in early June), presuming no further depreciation.

The Ministry of Economic Development expects investments to fall by 14 percent, imports by 40 percent, and real wages by more than 6 percent. Considering that investment amounts to 20 percent of GDP, and the rest is essentially consumption, elementary arithmetic would indicate a decline of 7.6 percent. That would be moderated by an increase in net exports of perhaps 2 percent of GDP, leaving us with a GDP decline of about 5.5 percent. The World Bank presumes a fall in consumption of 5.3 percent and a decline in gross capital formation of 15.3 percent.

In fact, the contraction is likely to be greater. Since November 2014, real wages have fallen sharply, by 9 percent in the first quarter of 2015. Considering expected cuts in public expenditures, the decline is likely to be even greater. If real consumption falls by 8 percent this year, that would deduct 6 percent from GDP. Investment will plummet because of sharply falling demand and the liquidity freeze. A more reasonable assumption would be a fall of 20 percent, which would be mean a deduction of 4 percent from GDP. Together the decline in investment and consumption would add up to a decline in GDP of 10 percent. Two this should be added the increase in net exports, which would reduce the decline to 8 percent. It is too early to say how much output will decrease, but all preconditions are worse and more likely to last than in 2009, when as mentioned earlier, GDP contracted by 7.8 percent. The biggest source of uncertainty is the oil prices that have recovered to some $65 per barrel in May and June 2015.

In late November, the onset of economic crisis put Russian society in a state of shock. Initially, people ran to the shops and bought whatever they could before new and higher import prices were introduced. As a result, sales and production numbers in December looked suspiciously reassuring. In early 2015, however, the impact of sudden poverty has been seen in steep drops in retail sales, especially of cars. Because the value of the ruble had fallen by half, prices of imported goods are twice as high as they were. Many imports became prohibitively expensive. In 1999, the combination of a large devaluation, free capacity and creative destruction kick-started Russian manufacturing. Putin has expressed hopes for such a development this time as well, but it did not occur in 2009 and it is unlikely this time around because of the poor business environment and the dominance of big state corporations. At the end of 2014, Russia had practically full employment, with an official unemployment rate of only 5.1 percent, but that has risen to 5.8 percent. Occasional official assurances that the Russian economy has reached the bottom seem unfounded. Rather, there was a calming of the market in April and May, but it is uncertain if it will last. Notably, industrial production that had held up well started falling sharply (by 4.6 percent) in April.

The mood among foreign companies doing business in Russia is miserable. They are being hit from all sides. Highly dependent on imports, they suffer from the sharp devaluation at the same time as domestic demand is plummeting. The automotive companies are quickly reducing or even closing down their Russian operations. Western companies with high public profiles, such as Coca-Cola or McDonald's, have been subject to official harassment and hostile government-supported public campaigns. The few remaining Western banks are struggling with currency and credit losses connected with devaluation and recession. The oil companies, notably ExxonMobil, have been hit by Western energy sanctions, and the sanctions on the finance sector have been harmful all around. An already terrible situation can be expected to get worse.

Likely Policy Responses by the Russian Government

To judge how the Russian government has reacted to this sudden crisis, this paper first looks at the policy declarations of the all-dominant President Vladimir Putin. Next, it examines how the Russian government functions in its policymaking. Finally, it will discuss actual policy.

In December 2014, as the financial crisis hit Russia with full force, Putin made two major public appearances: his annual address to the Russian Federal Assembly in the Kremlin on December 4 and his annual big press conference on December 18. Amazingly, in these venues he said a minimum about economic policy. He reassured his vast audiences that the economic situation was quite good, blamed external forces for any problems, offered no changes in the government's approach the economy, and expressed the hope that things would get better. Listening to Putin, you would think there was no crisis.

Indeed, he avoided the very word "crisis." He even protested when journalists invoked the term in the context of his country's economy, although he was happy to talk about the "Ukrainian crisis" or even the [European] "continental crisis." With a careful understatement, Putin referred to the financial crisis as the "current situation," attributing it to foreign meddling. "The current situation was obviously provoked primarily by external factors," he said. "However, we proceed from the view that we have failed to achieve many of the things that were planned and that needed to be done to diversify the economy over the past 20 years."[9]

With regard to how the Kremlin will handle this allegedly nonexistent crisis, Putin only offered two vague thoughts: applying the lessons from 2008 and rebounding on the back of global economic strength. "What do we intend to do about this? We intend to use the measures we applied, and rather successfully, back in 2008. In this case, we will need to focus on assistance to those people who really need it…. We would certainly be forced to make some cuts."[10] However, as discussed above, if that is success, what would failure be?

Putin continued: "However, it is equally certain—and I would like to stress this—that there will be what experts call a positive rebound. Further growth and a resolution of this situation are inevitable for at least two reasons. One is that the global economy will continue to grow, [although] the rates may be lower, but the positive trend is sure to continue. The economy will grow, and our economy will come out of this situation."[11] (He failed to mention a second reason.)

He clarified his thinking by stating that he had no idea when the economy would turn around. "How long will this take? In a worst-case scenario, I believe it would take a couple of years. I repeat: after that, growth is inevitable, due to a changing foreign economic situation among other things. A growing world economy will require additional energy resources. However, by that time I have no doubt that we will be able to do a great deal to diversify our economy, because life itself will force us to do it. "[12] He omitted the fact that Russia lost a decade of economic growth with the collapse of communism after the end of the last oil boom. In the end, his only hopes were the strength of external markets and the cushion of Russia's international reserves. As noted previously, these are shaky pillars on which to build a recovery.

The sole positive message came later on, when he said that Vladimir Yevtushenkov, a Russian oligarch charged with money laundering, would be freed from house arrest and that the charges would be dropped, suggesting some softening by the Kremlin toward big business.

In the first quarter of 2015, Putin held a series of meeting with a dozen senior economic officials. The main outcome was the adoption by the government, on January 27, of a package of 60 anti-crisis measures. But Putin maintained his public line from December. To avoid the word "crisis," the program was called the "Plan for Sustainable Economic Development and Social Stability in 2015" (though it was commonly called the anti-crisis plan). He continued to insist that the problems were coming from abroad, rooted in low levels of growth in the Western world.

Again, Putin reckoned that all the government had to do was to repeat its anti-crisis policy of six years ago: "This is not the first situation of this kind that we are going through. In 2008–2009 we went through the same thing. Then it was also a crisis that came from outside. Let me remind you that it started with the collapse of the mortgage system in the United States and then it touched other countries, including ours. Now as well, one of the main causes of the situation in the economy is the situation on foreign markets, in this case for raw materials, which is seriously reflected also here."[13]

Three weeks later, Putin made his clearest policy declaration: "Overall, the agenda is clear of course… Our tasks include diversifying the economy, creating conditions for faster growth, creating the right environment, improvement management at every level of power… stabilizing the currency and of course keeping our macroeconomic indicators on course."[14] This statement does not go much further than to say that Russia wants to do everything good and nothing bad. The president avoided the difficult questions of allocation and said nothing about reform.

The anti-crisis plan's measures would have a total cost of $38 billion, or 3 percent of the current GDP of $1.2 trillion, compared with the bailout of $200 billion in 2008–2009, which was then 10 percent of the GDP of $1.9 trillion. This drop reflects the tighter fiscal situation. The government proposes to recapitalize 27 major banks, which would consume two-thirds of the anti-crisis allocation. Sberbank's authoritative Chairman Herman Gref has suggested that a realistic amount needed for bank recapitalization in 2015 would be $50 billion. It is quite possible that most of the anti-crisis package will be devoted to that purpose, which would make good sense. Worse, 199 strategic companies irrespective of ownership or efficiency have been singled out for assistance and loan guarantees, similar to 2008–2009. Putin has nixed any proposals of pension reform, notably to raise the very low retirement age of 55 for women and 60 for men, and no structural reforms are on the agenda. The best that can be said about this plan is that it will not waste too much public money unlike the 2009 bail out.

The great improvement since 2009 is the altered exchange rate policy that Russia has moved from a pegged exchange rate with gradual devaluation to a floating exchange rate policy. This has helped the CBR to economize on reserves. The budget demonstrates the real problems. Ever since the 1998 crash, the Russian government has taken pride in an orderly budget process and adopted its budgets on time. But this year has been different. On March 16, the government submitted its budget revision for 2015 to the State Duma, which adopted it in April.

The budget was based on the latest forecast of the Ministry of Economic Development. Initially, the Ministry of Finance requested overall budget cuts of 10 percent in nominal terms. Given that current inflation of 16 percent, this would mean substantial real cuts of one-fourth of the budget. Not surprisingly, all powerful interest groups demanded to be exempted, and they were getting away with that. The key sectors exempted are defense and security, stadiums and infrastructure for the men's soccer World Cup in 2018, and agricultural subsidies and medicine, amounting to almost half of public expenditures. The budget deficit would then be 3.7 percent of GDP, which would not be worrisome—if it were accurately calculated. The Ministry of Finance wants to use $58 billion of the remaining $76 billion in the Reserve Fund. In addition, a large but so far unspecified share of the National Wealth Fund is supposed to be allocated to infrastructure investments and possibly bank recapitalization. Thus, Russia may exhaust most of its sovereign wealth funds on public expenditures this year.

The sectors that will definitely be hit are all those directly influencing the standard of living: health care, education, transportation and pensions. The federal government is fudging its math by decentralizing the budget cuts to state agencies and regional governments. The lower levels of government are told to cut 10 percent of the nominal expenditures, but they are given the choice of how to do so. Russia is only in the beginning of this process, but so far the authorities appear to be more keen on cutting wages than staff, just as was the case in the early 1990s, when state enterprise managers were more interested in having large numbers of workers to use as a negotiating tool with the federal government rather than to turn a profit.

This is the first time since Putin came to power in 2000 that Russian citizens experience a significant decline in their standard of living, and their reaction remains an open question. Moscow sociology professor Natalia Zubarevich divides Russia into four groups. "Russia 1," Moscow and St. Petersburg, is too well off to rise in opposition to the government. But she warns of coming social instability in "Russia 2," the large industrial cities with 250,000 to 1 million inhabitants that make up 30 percent of Russia's population. "Russia 3" constitutes small towns and the countryside, which are dominated by old and passive people. These three make up 90 percent of the population; a final tenth is ethnic minority territories, mainly in the Northern Caucasus, of little concern to the rest of Russia, allowing the Kremlin to use unlimited force.

A fundamental problem is that the Russian economic policymaking has collapsed into "manual management" in the hands of the president. Traditionally, the council of ministers, led by the prime minister, has managed policymaking and forced compromises between ministers. Today, however, Prime Minister Dmitry Medvedev appears to have no power. Instead, the security council with no economic policymakers is the real government, and economic decisions are made between the president and one minister or state enterprise manager at a time, with ad hoc crisis meetings with a dozen or so senior economic policymakers being the exception.

The Russian government's policy response is pretty clear and it can be summarized as "less of the same." A considerable sense of macroeconomic responsibility prevails. Substantial budget cuts will be undertaken, while the changes in the tax system are small, but the authorities do not seem to realize how precarious the situation is. At present, only two policies could only make a difference.

The first option for the Russian government would be to end warfare in eastern Ukraine to persuade the West to in turn end its financial sanctions. Until that is done, Russia will continue to bleed reserves, and given that $29 billion has already exited the country in the first rather quiet months of 2015, larger outflows are likely when the scarcity becomes evident to all.

The second option would be to carry out substantial structural reforms to level the playing field in the Russian economy, but that would undermine the stability of the whole economic and political system. Therefore, no major structural reforms are likely. If neither option is chosen, Russia will stay in a dead end.

Policy Recommendations to US and European Governments

So what should the United States and the European Union do about Russia? It is important to have the priority of objectives clear. Today, after one year of Russian military aggression against Ukraine, the obvious first goal is to stop that aggression. The combined US-EU position was clearly spelled out in a White House note on a phone call between President Obama and German Chancellor Angela Merkel on March 18:

> The two leaders agreed on the need for full and prompt implementation of the three Minsk

agreements in order to reach a lasting and peaceful resolution to the conflict. They reiterated their agreement that there will be no easing of sanctions imposed on Russia until it has fulfilled all of its Minsk commitments. The President and the Chancellor also agreed on the continued importance of providing economic support for Ukraine as it implements necessary reforms.[15]

At their meeting in Schloss Elmau in Germany on June 8, the G-7 leaders adopted a similar statement:

We recall that the duration of sanctions should be clearly linked to Russia's complete implementation of the Minsk agreements and respect for Ukraine's sovereignty. They can be rolled back when Russia meets these commitments. However, we also stand ready to take further restrictive measures in order to increase cost on Russia should its actions so require. We expect Russia to stop trans-border support of separatist forces and to use its considerable influence over the separatists to meet their Minsk commitments in full.[16]

Thus the first aim of Western leaders is to force Russia to implement the Minsk agreement, which calls for Russia's withdrawal of troops and military equipment from eastern Ukraine and restoration of Ukrainian control over the border.

The second Western aim remains to integrate Russia better into the global economy, but obviously this cannot be pursued until the Ukraine standoff is resolved. Renewed endeavors at economic integration will be left to the future. This policy is clearly stated in two paragraphs in the new US National Security Strategy of February 2015. After having condemned Russian aggression, it proceeds to call for aid for Ukraine: "Russia's aggression in Ukraine makes clear that European security and the international rules and norms against territorial aggression cannot be taken for granted. In response, we have led an international effort to support the Ukrainian people as they choose their own future and develop their democracy and economy." The other element is sanctions against Russia: "And we will continue to impose significant costs on Russia through sanctions…"[17] In both aid and sanctions, the current US administration is uncommonly focused on cooperation with the EU, and the EU has responded positively to this coordination.

The joint Western response has been to impose sanctions on Russia. The first rounds of sanctions, in March 2014, were directed against individuals, blocking visas and freezing assets of people involved in the Russian annexation of Crimea. The United States in general has taken aim at the cronies of Putin, while the European Union has gone after more members of former Ukrainian president Viktor Yanukovych administration. Russian opposition politicians, notably Alexei Navalny, have called for the extension of personal sanctions to 1,000 top Putin officials and their families, aiming at "the propagandists of war, the ones who finance the war, the real party of war."[18] Putin's wealthiest crony, Gennady Timchenko, has seen his assessed wealth plummet from a peak of $24.6 billion in 2012, according to Russian Business Consulting, to a current Forbes rating of $10.7 billion. Because of the sanctions, he can no longer obtain international banking guarantees and therefore can no longer operate as chief contractor of Gazprom, his main source of income.

In July 2014, both the United States and the European Union imposed substantial sectoral sanctions on Russia for one year. The military sanctions cover obvious items, but exclude a number of dual technologies that perhaps should be included. The energy sanctions focus on future development of deep-sea, Arctic and tight oil. Given that these are the three big future directions of Russian hydrocarbons development, this matters for the future but not the short term. As discussed above, the really important sanctions target the financial sector. Initially, they were supposed to be aimed only at financing with a duration of more than one month. Contrary to expectation, they have turned out to include all financing from the West, and the consequence has been the liquidity freeze discussed above.

At present, two discussions are ongoing. One centers on whether the financial sanctions should be reinforced, notably by removing Russia from the SWIFT banking clearance system. SWIFT (the Society for Worldwide Interbank Financial Telecommunication) is a private cooperative that enables financial institutions to send and receive information about financial transactions in a secure, standardized and reliable environment. If Russia were disconnected as Iran has been, it would slow down but not hinder interbank transactions, and credit cards are not cleared through SWIFT. The other discussion is whether the Western powers' stance is sufficiently cohesive to maintain the current financial sanctions.

Until recently, many Western and Russian financiers presumed that the US and EU sanctions would lapse in July 2015. But as the Peterson Institute's Gary Hufbauer, Jeffrey Schott and Kimberley Elliott have concluded from their empirical study of Western economic sanctions since World War II, sanctions tend to be inert and are rarely eased until they accomplish their aim, which happens in only 30 percent of all cases.[19] Unless Russia withdraws its military forces from Ukraine, the West is unlikely to ease the sanctions. The European Union is particularly inert in its behavior; it is unlikely to change a policy that it has once adopted unlike the reasons to do so are very strong. Given that Western companies have lost their shares of the swiftly shrinking Russian market, they are becoming less interested as well, and their lobbying to ease the sanctions is subsiding. Therefore, it did not come as any surprise that on March 19 the European Council agreed to extend the sanctions until the end of 2015, with this formulation: "The European Council agreed that the duration of restrictive measures against the Russian Federation, adopted on 31 July 2014 and enhanced on 8 September 2014, should be clearly linked to the complete implementation of the Minsk agreements, bearing in mind that this is only foreseen by 31 December 2015."[20]

Needless to say, the severe sanctions make any attempt at economic integration impossible. Foreign enterprises are quickly cutting down their activities in Russia and withdrawing, mainly because of the big depreciation of the ruble, but also because of the deeply troubled business and political climate. Expatriates are leaving Russia en masse. According to Global Trade Alert, since November 2008 Russia has violated WTO rules more than any other G-20 country apart from India.[21] Given the lopsided structure of the EEU, it would make little sense for the EU to engage with it. Nor would it make any sense to start thinking of a future bilateral free trade agreement between Russia and the EU, given both the sanctions regime and the mess of the EEU.

Despite these difficulties, the current tension with Russia should be seen not only as a problem, but also as an opportunity. Europe has a long-standing issue with the stability of natural gas supply from Russia, as prices have varied widely by country and former communist countries have experienced multiple cuts to supply amid disputes with Russia. A Swedish study found that Moscow used "coercive energy policy" of this kind 55 times from 1991 until 2006.[22] The current Russian weakness, combined with the global gas revolution, offers Europe an excellent opportunity to reform the marketplace for natural gas in Europe. To this end, the European Commission has just presented a far-reaching proposal for a new European Energy Union. Among the goals of this initiative is to make the continent's gas market more efficient—not to harm Russia, but to secure European energy security. This has been a long-standing ambition of the Commission, but previously European companies allied with Gazprom supported its restrictive market practices. Now, the unbundling of transportation and production of energy has gained political support, and Gazprom's price discrimination among different countries is seriously questioned. A more open market for energy should lead to greater efficiency, even if Gazprom's supporters in Europe warn of increased market instability.

Since Russia started military aggression against Ukraine in February 2014, US and EU policy toward Russia has been uncommonly united. The tensions between the two are also less than on most other important question (internal tensions within the US and the EU appear greater). The initial sanctions against individuals seem to have had significant impact, judging not only from the documented effects on wealthy Putin cronies, but also from the calls from Russian opposition leaders to broaden the sanctions. Among the sectoral sanctions, those on the finance sector have had far greater impact than expected. This reduces the demand for more sanctions in that area, such as cutting Russia out of the SWIFT system.

The dominant view appears to be that the US and EU sanctions should and can be maintained until Russia fulfills the conditions of the Minsk accords and effectively removes its troops and armament from eastern Ukraine. While it is beyond the scope of this paper, an important part of Western policy toward Russia should be to provide Ukraine with sufficient support so that its democratic and market economic transformation finally can succeed. Meanwhile, Europe should take the opportunity to move forward with securing stronger energy independence, and the EU formation of the Energy Union seems a promising step toward this goal.

About the Author

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Åslund served as an economic adviser to the governments of Russia in 1991–94 and Ukraine in 1994–97. He was a professor at the Stockholm School of Economics and the founding director of the Stockholm Institute of East European Economics. He has worked as a Swedish diplomat in Kuwait, Poland, Geneva, and Moscow. He is a member of the Russian Academy of Natural Sciences and an honorary professor of the Kyrgyz National University. He is chairman of the Advisory Council of the Center for Social and Economic Research (CASE), Warsaw, and of the Scientific Council of the Bank of Finland Institute for Economies in Transition (BOFIT).

[1] I want to thank all the participants at the Bertelsmann Foundation meeting in Washington on April 16, 2015. I have tried to incorporate their comments as far as possible. Vijay Khosa has offered excellent research assistance.

[2] I have discussed the Russian postcommunist economic transformation in Åslund, A., *Russia's Capitalist Revolution*. (Washington, D.C.: Peterson Institute for International Economics). A general source on the Russian economy: Åslund, A., Guriev, S., and Kuchins, A., eds. (2010). *Russia after the*

Global Economic Crisis. (Washington, D.C.: Peterson Institute for International Economics and the Center for Strategic and International Studies).

[3] When not explicitly referring to Russian statistics, this paper uses IMF World Economic Outlook statistics.

[4] Karen Dawisha has best captured the situation in her book *Putin's Kleptocracy: Who Owns Russia?* (New York: Simon & Schuster, 2014).

[5] The story of Rosneft's rise is told by Thane Gustafson's *Wheels of Fortune: The Battle of Oil and Power in Russia* (Cambridge, Mass: Belknap Press of Harvard University Press, 2012).

[6] Nemtsov, B., and Milov, V. Putin and Gazprom. *Novaya Gazeta*, February 9, 2008.

[7] It is likely to change composition. The current account surplus is set to rise because of the financial sanctions, the service deficit to decline with contracting merchandise trade, and the remittances to decline with falling dollar GDP.

[8] Allie E. Bagnall and Edwin M. Truman "Progress on Sovereign Wealth Fund Transparency and Accountability: An Updated SWF Scoreboard," Policy Brief 13-19, Peterson Institute for International Economics, August 2013.

[9] A full English-language transcript of Putin's press conference is available at http://eng.kremlin.ru/transcripts/23406.

[10] Ibid.

[11] Ibid.

[12] Ibid.

[13] Putin made these comments at a Jan. 21 meeting with government members; the transcript is available at http://eng.kremlin.ru/transcripts/23507.

[14] These comments came at a Feb. 13 meeting with economic experts; the transcript is at http://eng.kremlin.ru/transcripts/23602.

[15] "Readout of the President's Call with Chancellor Angela Merkel of Germany," March 18, 2015, www.Whitehouse.gov.

[16] "G-7 Leaders' Declaration," Schloss Elmau, Germany, June 8, 2015, www.Whitehouse.gov.

[17] The White House (2015). *National Security Strategy, February 2015.* Retrieved from https://www.whitehouse.gov/sites/default/files/docs/2015_national_security_strategy.pdf.

[18] Hille, K. Blacklist Putin Loyalists, Says Navalny, *Financial Times,* March 11, 2015.

[19] Hufbauer, G.C, Schott, J., Elliott, K., and Oegg, B. (2008). *Economic Sanctions Reconsidered*, 3rd edition. Washington: Peterson Institute for International Economics.

[20] European Council, "European Council Conclusions on External Relations (19 March 2015),"
http://www.consilium.europa.eu/en/press/press-releases/2015/03/conclusions-russia-ukraine-european-council-march-2015/

[21] Global Trade Alert. (2014). *The Global Trade Disorder*. Retrieved from http://www.globaltradealert.org/16th_GTA_report

[22] Jacob Hedenskog and Robert L. Larsson, *Russian Leverage on the CIS and the Baltic States*, Stockholm: Swedish Defense Research Agency, 2007, pp. 46-57.