

## The EU-Ukraine-Russia Sanctions Triangle

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### The generally, but not universally poor track record of sanctions

Economic and political sanctions are known to be ineffective in most cases. Witness EU sanctions against China after Tiananmen Square in 1989, and against Uzbekistan after Andijan in 2005. One study of 174 cases proposed that 34% of sanctions had at least been partly successful,<sup>1</sup> but this was contested by another analysis of the same data set, arguing that only 5% had been successful.<sup>2</sup> A recent CEPS study looked at four cases of EU sanctions in some depth – against Burma, Zimbabwe, Iran and North Korea.<sup>3</sup> Overall, the analysis pointed to the obstacles that hinder the achievement of the desired results. The Iran case is still an important open question.

Why should sanctions be used so often when they have such a poor track record? According to a former UK ambassador to the UN, the reason is that: “[T]here is nothing else between words and military action if you want pressure to bear on a government” (Jeremy Greenstock).<sup>4</sup> Sanctions may therefore often become political statements more than anything else, and gestures to assure a minimal consistency between words and actions in the context of the domestic as well as the international political debate.

The sanctions doctrine seems to have been adapted to these disappointing results by devising a new formula described as ‘targeted’ sanctions.<sup>5</sup> The idea here is to avoid indiscriminate measures that might hurt the general population more than the leadership, and to aim instead at individuals who can be held responsible, or at key economic sectors. This is currently in evidence in both the EU and US sanctions against Russia, with individuals targeted with visa bans and asset freezes, and specific business sectors or sectors of the economy and financial system.

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<sup>1</sup> Gary Hufbauer et al., *Economic Sanctions Reconsidered*, 3<sup>rd</sup> edition, Petersen Institute, November 2007.

<sup>2</sup> Robert Pape, “Why sanctions still do not work”, *International Security*, 1998.

<sup>3</sup> Clara Portela, “The EU’s use of targeted sanctions: Evaluating Effectiveness”, CEPS Working Document No. 391, Brussels, March 2014.

<sup>4</sup> “Do economic sanctions work?” (<http://www.bbc.co.uk/news/world-middle-east-10742109>), 26/07/2010.

<sup>5</sup> See Portela, op. cit., for a detailed account of this thinking.

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The EU's sanctions are aimed at stopping "Russia's actions destabilising the situation in Ukraine".<sup>6</sup> More precisely, Russia is seen in its Ukrainian interventions to have broken every basic principle in the Helsinki Final Act of 1975 concerning respect for the territorial integrity and sovereignty of states, and repudiation of the threat or use of force. The Helsinki norms of the European security order were not a Western invention, but negotiated with Brezhnev's Soviet Union as a pan-European act of historic significance. In addition, the current Russian interventions in Ukraine have been supported by a massive disinformation campaign about the struggle against the 'fascists' in Kiev, while at the same time denying Russia's own military intervention, first in Crimea and then in east Ukraine.

The present set of sanctions around the EU-Ukraine-Russia triangle have also become an exceptional case in seeing sanctions and counter-sanctions between two major global actors, both directly and indirectly through the third party at the heart of the conflict. The dynamics of the impacts and interactions are far more complex than any simple generalisation that sanctions do or do not work.

### EU sanctions against Russia

These have been intensified stage by stage, as the initial packages had no impact. In total they now comprise:

- *Diplomatic sanctions:* The G8 summit scheduled to take place in Sochi in June 2014 became the G7 in Brussels; the EU-Russia summit, also scheduled for June in Sochi, was cancelled; talks on visas and a new agreement have been suspended; various bilateral cooperation programmes have been suspended.
- *Individualised sanctions:* The number of EU visa bans and/or asset freezes have been progressively extended to a total of 119 persons and 23 entities in Russia and Crimea.
- *Economic sanctions:* New operations by the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD) are to be suspended (Russia had become the biggest beneficiary of EBRD operations); imports from Crimea are banned, unless certified by Ukraine; exports of military and dual-use goods are banned; export licenses will be denied for energy-related equipment (deep water development in the Arctic, and shale); access to EU capital markets and related services is severely restricted for targeted major Russian banks and corporations (*Sberbank, VTB, VEB, Gazprombank and Rosselkhozbank*). There is talk of suspending Russia from the SWIFT international bank payments system, but this is not yet decided.

As regards impact, the Russian leadership purports to be unconcerned by the diplomatic sanctions. G8 does not matter anymore, and G20, which would be more serious because it brings in all the emerging powers, is not touched. The visa bans and asset freezes would not seem to be of concern to most of the targeted individuals, who, on the contrary, are more likely to feel they have received a medal of honour for having regained Crimea and raised Russian flags over Donetsk and Lugansk. Most of these individuals will not have foreign assets, and can choose other tourist destinations, from Turkey to Thailand.

The main economic sanctions are very serious for Russia, however. While the G8 was suspended, a newly reinvigorated G7 has adopted a common position on sanctions. The financial sanctions are already having an evident impact. Former Finance Minister Alexei Kudrin has spoken of his serious concerns for macroeconomic developments, at least in the longer run, since for the moment Russia has large financial reserves of around \$470 billion

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<sup>6</sup> Council Regulation (EU) No 960/2014 of 12.9.2014, amending Regulation (EU) No 833/2014 of 31.7.2014.

that could be drawn upon to compensate enterprises and banks that need to refinance borrowing on international capital markets. How serious these concerns are for the Kremlin leadership is hard to say. In Western financial markets Russian enterprises are now virtually shut out. This goes beyond the individualised banks, since there is a broader market refusal to take on perceived political risks, with the EU and US having said clearly that the sanctions can be further extended (or retracted). The arrest of Vladimir Yevtushenko on September 17<sup>th</sup> has raised apprehensions. Informed sources in Moscow interpret this arrest as an attempt to seize his assets in order to be transferred to *Rosneft*, which has \$42 billion worth of credits outstanding that need to be refinanced. Furthermore, it is reported that the top three Russian banks are in need of \$75 billion to re-finance borrowings over the next year. Just as this affair was beginning to look like 'Yukos 2', several leading personalities spoke out against his arrest in public,<sup>7</sup> to the point that Yevtushenko was provisionally released from house arrest. These kinds of protest towards the Kremlin are rare acts for such prominent individuals.

The key issue is how far the Russian leadership is worried about the progressive isolation of the economy from trade, investment and funding from the West. One argument advanced by 'liberals' is that this will push the Russian economy into a state of stagnant backwardness. Others, for example more nationalist spirits in the Duma, see this more positively as an opportunity for Russia to become more independent from the West. Hard macroeconomic realities are becoming apparent, however. The rate of growth in 2103 was already seriously decelerating, and GDP growth is forecast by the World Bank for 2014 to be only 0.5%, after a fall registered in the first quarter.<sup>8</sup> The Western sanctions hurt the general business climate as well as specific sectors, and are now combining with a serious decline in the oil price (of 28% from a peak of \$125/barrel in April 2011 to \$89 by 7 October 2014), with oil revenues serving as a crucial resource for the Russian budget.

Russian supplies of gas have not been subjected to sanctions, although the EU seeks to diversify its supplies, for which there are ample possibilities in the medium to long run. The European Commission has published a list of 10 short-term projects (until 2016) and 13 medium-term projects (until 2020), consisting mainly of gas pipeline network connections, reverse flow capabilities and increased LNG reception facilities to enhance supply options. There are also possibilities to increase supplies from Norway, North Africa and the Caspian. 'Optionalities' is the key word being used to characterise this set of projects, which will permit the radical reduction of the EU's dependence on Russian gas supplies if political circumstances make this necessary.<sup>9</sup> For the moment, however, a stoppage of imports from Russia would begin to hurt the European economy, after some months of running down stocks. Moscow would seem to be in a wait-and-see mode before it concludes that its gas revenues from Europe are set to drop drastically. However, when Moscow sees this prospect becoming credible, even only by 2020, it will have another important negative factor to include in its economic assessments.

There is also the *Mistral* affair. The two huge warships, whose supply from France was contracted by Sarkozy's government, are ideal instruments for Russia to deploy its military power anywhere on the seas and oceans, but first of all in the Black Sea as a threat to Ukraine and Georgia, and then as a presence in the Mediterranean and Pacific. The contradiction in principle with EU sanctions strategy was initially glossed over by the exclusion of pre-existing contracts. But the contradiction became too embarrassing, and France announced

<sup>7</sup> Including Alexander Shokhin, President of the Enterprises Union, and Andrei Kostin, President of VTB bank.

<sup>8</sup> World Bank, *Russian Monthly Economic Developments*, September 2014.

<sup>9</sup> European Commission, "European Energy Security Package", COM(2014)330 final, 28 May 2014.

postponement of delivery of the first Mistral ship shortly before the NATO summit in Wales, without cancelling the contract.

### Russian counter-sanctions against the EU

Food imports from the EU, the US, Norway and Australia have been banned for one year. This has hurt some EU producers and suppliers, but the proportions are marginal.

	Billion euro	% EU GDP
EU GDP	13,473	100
EU total exports worldwide	1,733	13
EU agri-food exports worldwide	120	0.9
EU agri-food exports to Russia	12	0.09
Sanctioned EU agri-food exports to Russia	5	0.04
<i>Minus</i> products already restricted early 2014	3.5	0.03

Sources: European Commission, Eurostat and DG Trade.

The European Commission estimates that about 40% of EU agri-food exports to Russia are being sanctioned. Of the €5 billion worth of flows that are hit, €1.5 billion was already affected by restrictions imposed early in the year. The overall impact of the new sanctions may thus be estimated to be 0.03% of EU GDP. The Commission also intervened in various markets for fresh agricultural produce in August to reduce the market impact of the sanctions, putting certain quantities into storage.

There is an unquantifiable negative macroeconomic impact through damage to the business climate, which at a time of delayed recovery from recession is a serious matter. The policy response blends in with the overall task of getting resumed macroeconomic growth, however, for which the European Central Bank announced, on October 2<sup>nd</sup>, a huge programme of asset purchases amounting potentially to one trillion (a thousand billion) euro.

### Russian sanctions against Ukraine and Moldova<sup>10</sup>

These sanctions have been very extensive for Ukraine, as follows:

- July 2013, ban on *Roshen* chocolates (company controlled by the subsequently elected President Poroshenko)
- August 2013, severe customs delays for Ukraine exports to Russia
- October 2013, ban on Ukrainian supplies of railcars, subsequently partly lifted
- February 2014, ban on supplies from the largest Ukrainian poultry producer
- April 2014, ban on cheese supplies from five Ukrainian companies
- June 2014, ban on Ukrainian potatoes
- June 2014, stoppage of gas supplies to Ukraine
- July 2014, ban on Ukrainian dairy products
- August 2014, ban on Ukrainian supplies of alcoholic products

Most of these sanctions have been introduced on grounds of alleged non-compliance of Ukrainian supplies with Russian health or safety regulations. However, while the scientific

<sup>10</sup> For a more detailed account, see D. Cenusa, M. Emerson, T. Kovziridse and V. Movchan, "Russia's Punitive Trade Measures towards Ukraine, Moldova and Georgia", CEPS Working Document No. 400, Brussels, September 2014.

evidence for their justification is wholly non-transparent, the political motivation is obvious. The gas stoppage involves issues of price and debt, which are the subject of ongoing trilateral discussions with the Commission acting as mediator.

Russia has further adopted a law empowering it to cancel the free-trade preferences accorded to Ukraine under the CIS free trade agreement of 2011, but has not implemented these pending trilateral negotiations with the EU (see below). In response Ukraine has adopted a draft law authorising the reciprocal cancellation of trade preferences towards Russia, which is not expected to be passed into law until after the October 26<sup>th</sup> parliamentary elections.

Russia has also sanctioned Moldova with a similar list of agri-food restrictions, and in addition has, from 1 September 2014, actually cancelled the CIS free-trade preferences for Moldovan products, not just threatened to do so, as in the case of Ukraine.

It is notable that Belarus and Kazakhstan did not follow Moscow in these sanctions, which means a breach of their customs union. Belarus becomes a commercial and transport hub of supplies to Russia, with various Moldovan, Ukrainian and EU supplies of raw agri-food products being processed in Belarus to the point of becoming 'made in Belarus' from the standpoint of rules of origin, and therefore passing legally into a Russia free of tariffs. Furthermore, there is an unknown quantity of 'illegal' supplies.

### Trilaterisation, EU-Ukraine-Russia

On 12 September 2014 there was an important trilateral meeting of the European Commission, Ukraine and Russia, at Commissioner/ministerial level, at which Russia presented demands for amending the Association Agreement, which includes a Deep and Comprehensive Free Trade Area (AA/DCFTA). Part of the Russian argument was that measures were required to prevent the 'need' for Russia to proceed with the next phase of sanctions against Ukraine, notably the suspension of CIS tariff-free preferences (see above). The outcome of the meeting was an agreement by the Commission and Ukraine to postpone, until the end of 2015, the 'provisional application' of the DCFTA component of the Association Agreement. In exchange, Russia would not scrap the CIS free-trade preferences.

After the September 12<sup>th</sup> meeting the Russian Minister, Alexei Ulyukaev, wrote to Commissioner De Gucht, in a letter leaked to the press, seeking to put this agreement into due legal form, and to proceed with further trilateral talks to resolve outstanding issues.<sup>11</sup> The most practical of these may be the question of technical standards and SPS regulations for Russian exports to Ukraine for whenever Ukraine implements EU standards. But other Russian requests, such as to amend the AA/DCFTA, are presumably out of the question. The Ukrainian minister said that "not one word" would be changed. Further, it has been reported in the press that President Putin felt it necessary to follow up the Ulyukaev letter with his own letter to President Poroshenko and President Barroso, threatening immediate retaliation if Ukraine took any steps towards implementing the AA/DCFTA, and demanding its "systemic amendment", which would seem to mean an exorbitant widening of the September 12<sup>th</sup> agreement.<sup>12</sup>

A more constructive trilateral process has been underway on the conditions for resumption of supply of Russian gas to Ukraine. There have been several meetings of the Russian and Ukrainian energy ministers mediated by the European Commissioner for energy policy, Gunther Oettinger. Negotiations have progressed on the price and debt settlement

<sup>11</sup> <http://www.veooz.com/photos/WHU~Ezy.html>

<sup>12</sup> <http://www.reuters.com/article/2014/09/23/us-ukraine-crisis-trade-idUSKCN0H11T820140923>

conditions for resuming gas supplies at least for the coming months, to see though the winter. At the last trilateral meeting in Berlin on September 26<sup>th</sup>, a deal was tabled for a so-called winter package, under which Ukraine would pay \$3.1 billion of its debt to Russia by the end of the year in exchange for gas deliveries during the winter months at \$385 per 1,000 cubic meters. The deal is not yet finalised, however.

## Conclusions

The EU and the US have deployed mounting sanctions against Russia for the most fundamental reason, namely because the Kremlin, in its interventions in Ukraine, has broken every basic norm of the pan-European security order enshrined in the Helsinki Treaty of 1975. The NATO allies have said openly that they would not go to war with Russia over Ukraine. In these circumstances, in the apposite words of the former UK ambassador to the UN, there are no other means between words and war, apart from sanctions, of bringing pressure to bear. Of the EU and US sanctions against Russia, the effective closure of financial markets is far more important than the sanctions targeting individuals, and is hurting big Russian financial institutions. Russia's financial reserves can take care of immediate needs, but the longer the sanctions remain the greater the macroeconomic costs, to the point of potentially becoming damage of strategic importance, and notably so if the oil price continues to weaken and the EU progresses faster and credibly towards being able to do without Russian gas.

As regards Russia's counter-sanctions, the food import restrictions are of marginal significance. The damage to the European business climate is hardly welcome, but the much wider challenge of pulling the economy out of stagnation is being addressed though massive monetary policy intervention by the European Central Bank.

Russia's sanctions against Ukraine look like becoming counter-productive in simple economic terms by stimulating a switch in marketing efforts towards EU and world markets, away from the Russian market. More fundamentally, through its aggression Russia has engraved itself as an enemy in the minds of most Ukrainians, as was the case in Georgia with the 2008 war: thus soft power losses for Russia.

For the time being the sanctions and counter-sanctions between Russia and Europe formalise their mutual estrangement, with Europe's trust of the Kremlin having sunk to the lowest level since pre-Gorbachev times. Russia is perceived as supporting a new frozen conflict zone in east Ukraine and playing a long and opportunistic game, with partial and temporary alleviation of hostilities against Ukraine to abate the sanctions, leaving open scenarios for resumed offensive actions later, such as for seizing a land corridor down to Crimea. If, on the other hand, Russia demonstrated concrete, credible and long-term willingness to switch to a cooperative peace mode with Ukraine, the EU and the US would no doubt be happy to scrap the sanctions. In the absence of such signals and binding commitments, the logic would be to sustain the most significant economic sanctions for as long as it takes, with preparedness to intensify them.