ANALYSIS

Russian Economic Sanctions as Carrots and Sticks in the Near Abroad

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Abstract

Many observers have noted Russia's increasing economic assertiveness in the former Soviet space, especially its ability to control oil and gas supplies—as it is now doing in threatening Ukraine with a "cold winter." As this piece will show, though, Russia's influence in the near abroad includes many other instruments, all of which must be considered to gain a true sense of Moscow's expanding reach in the region. This economic power is rooted in the Soviet period, but has been carefully expanded under President Vladimir Putin. This article will outline some of the types of economic linkage Russia employs and give examples of their effects. Like its "masked warfare" in the security realm, Moscow has sometimes been able to hide its true intentions, concealing sanctions as "routine business decisions" or "bureaucratic measures." Yet these sanctions and incentives have played a key role in expanding Russia's reach around its borders.

All Roads Lead to Moscow

Russia's economic influence in what it considers the "near abroad" is rooted in the region's shared Soviet heritage. Since Russia was the largest unit of the USSR, it seemed that "all roads led to Moscow." The smaller republics needed Russia far more than Russia needed them. This dynamic still helps Russia to dominate the regional economy today.

For example, Russia had a central place in the USSR's energy network. It supplied most of the oil and natural gas used by the other republics, as well as some of their electricity. Even republics which had oil and gas could only ship their products into Russia, not to foreign markets. In industry, other republics often produced only part of a complex product, depending on Russian factories to supply most components. Even if production was located in a smaller republic, the ultimate purchaser would likely be in Russia. Similarly, in agriculture Russia was central; for example, republics might specialize in cotton farming (Central Asia) or wine production (Georgia). Most of their production was, again, destined for Russia—and of little interest to foreign countries. Finally, the same could be said for labor migration. Even in the Tsarist period workers from the Caucasus and Central Asia moved to Russia to find work. This continued in the Soviet era.

In the 1990s, though, this dependence fell greatly. The newly independent republics tried to build ties to the outside world, and thought they could defy Moscow with impunity. There were several reasons for this. First, with the Russian economy in free fall, Moscow found it hard to credibly threaten economic sanctions. If Russia cut trade ties with a recalcitrant partner, it would lose income—and any income was crucial in the lean Yeltsin years. Second, the rock-bottom price of oil and gas during these years blunted Russia's largest potential weapon. Third, economic decline limited Russian economic incentives. Russia could hardly offer loans when it was bankrupt, and access to its weak import market seemed a small incentive. Finally, and perhaps most importantly, under Gorbachev and Yeltsin what the Russians call the "power vertical" had broken down. Most of the economy was privatized, and the new owners naturally put profit ahead of state interests. Even the remaining state-owned firms, like Gazprom, seemed to act like private firms. This was the "era of the oligarchs," and the Kremlin seemed powerless to control the economy.

In the Putin era, all of these conditions have changed dramatically, and Russia's economic power in the "near abroad" has surged. Dramatic growth has given Russia the ability to offer loans and has made access to its market a lucrative incentive.[1] With its new wealth has come the ability to casually impose sanctions, even if they also impose costs on Russia. Oil and gas prices have surged, which allows Moscow to cut off a few troublesome customers and still reap revenue far higher than in the Yeltsin years. And of course the "power vertical" has been imposed firmly on the economy, allowing the Kremlin to enforce sanctions much more easily. There has been some renationalization, notably in the oil and gas sector. However, just as importantly, the private sector has been cowed to accept state priorities, even at the cost of profits. Defiant companies may now face such measures as tax investigations, claims of environmental damage and food safety inspections, any of which can shut a firm down as effectively as outright confiscation. Thus few businesses will protest when the Kremlin imposes costly sanctions—or offers costly economic incentives—in the "near abroad."

1 There is a huge gap between Russia's economy and those of its smaller neighbors. In 2013 the Russian GNP was estimated at about $2.1 trillion, which is 12 times larger than Ukraine's GNP ($175 billion), 132 times larger than Georgia's ($16 billion), and 264 times larger than Moldova's ($8 billion) (source: CIA World Factbook).

Oil and Gas Leverage

Both policy analysts and scholars quickly noted that energy has become the Kremlin's strongest economic lever. Natural gas is an especially powerful weapon; unlike oil, it can generally be delivered only through fixed pipelines, giving a supplier a natural monopoly; and as noted above, in the USSR, Russia controlled the key pipelines.

Under President Putin, Russia's gas power has been exploited ruthlessly. Many of the former Soviet republics—including the Baltic states, Belarus, Ukraine and Armenia—are totally dependent on Russian gas. The current Ukrainian crisis has been a particularly dramatic example, with Kiev facing a total gas boycott since June 2014. Earlier there were embargoes in the winters of 2006 and 2009. Georgia, in 2006, was hit with an even more dramatic cutoff. Its natural gas pipelines were simply blown up, an action which the Kremlin attributed to Chechen rebels—although most observers suspected the Russians themselves. However, Russia has discovered that more refined methods can be just as effective. Most notably, Russia has practiced a careful system of political pricing of gas. Customers who support Russia receive dramatic discounts. Belarus, Armenia, Ukraine under the pro-Russian Presidents Kuchma and Yanukovych, and the Kremlin's client quasi-states of South Ossetia, Abkhazia, and Transdniestria all have received massive gas subsidies. Sometimes these are nakedly linked to a specific political concession. For example, when Yanukovych took office in 2010 and agreed to extend Russia's lease on naval bases in the Crimea, he was rewarded with a 25 percent rebate on natural gas. At the same time, customers seen as anti-Russian—such as Georgia, the Baltic states, Moldova, and Ukraine under Presidents Yushchenko and Poroshenko—face punitive price increases. For example, in 2004 at the end of President Kuchma's reign, Ukraine paid roughly $50 per thousand cubic meters (TCM) for gas. In 2014 the Kremlin demanded almost $500 per TCM—a ten-fold increase in ten years. Furthermore, Russia has discovered it can also impose political debt arrangements. Compliant states are allowed to buy gas with generous credit terms—low interest, delayed payments, even debt forgiveness in some cases. Opponents, on the other hand, must pay debts quickly, with high interest rates, and are even asked for cash payment in advance—as is now being demanded of Ukraine. The beauty of these methods is that, in contrast to gas embargoes, they are vastly profitable for Russia. Thus the Kremlin can simultaneously weaken opponents and strengthen itself.

Even the former Soviet republics which produce gas and oil have felt Russian pressure. Initially they all had no other outlet for their production than through Russia. In the lenient Yeltsin years they were sometimes allowed to use Russian pipelines for a modest transit fee; for example, in the 1990s Ukraine could purchase cut-rate Turkmen gas to supplement imports from Russia. This practice was quickly ended under Putin. Russia became a ruthless monopsony buyer, putting it in the enviable position of being able to resell some countries' gas for a 400 or 500 percent profit. Naturally, this gave the Kremlin great influence. The targeted states have tried to find other outlets, often over Russian protests. Azerbaijian, for example, now has a pipeline to the West via Turkey and Georgia, while Turkmen gas can flow east to China.

Moscow's energy measures have often been camouflaged as "business decisions." Massive price increases are disguised as efforts to reach "market prices." Yet this is transparently false. Anti-Russian states are hit with increases which are vastly higher than those imposed on "normal" customers. To cite but one case: Gazprom currently demands far more from Ukraine than from the much wealthier states in the EU. Subsidized states, meanwhile, are granted absurdly low prices—and other favors. For example, Gazprom has spent heavily to build pipelines into the tiny, poor enclave of South Ossetia to support rebel groups there. This investment makes no economic sense, but has clear political logic.

Trade Leverage

While Russia's energy leverage has generated large headlines, non-specialists have sometimes failed to note the Kremlin's extensive trade leverage. Yet this, too, has been a powerful source of both economic sticks and carrots.

As with energy, Russia's client states are rewarded with generous trade deals. Their uncompetitive products are bought by Russia, giving them access to a lucrative market. This method has been practiced by hegemonic states for many years. As Hirschman notes in his classic study of Nazi economic policy, for example, in the 1930s Hitler's Germany cemented its ties to states such as Romania and Hungary through generous, long-term deals to buy their exports.[2] Russia has followed the same model. For example, in periods of amity between Russia and Ukraine, Moscow happily bought outmoded locomotives from Luhansk and elderly Antonov transport planes made in Kiev, just as it continues to buy tractors from Minsk and cotton from Central Asia. Such purchases not only provide immediate economic incentives; they foster longer-term dependency, keeping alive outdated Soviet-era economic ties and creating powerful constituencies supporting continued bonds with Russia.

2 Hirschman, Albert 1945. *National Power and the Structure of Foreign Trade.* Berkeley: University of California Press.

This could be seen most recently in the Donbass uprising, where a major motivation of the rebels was to maintain jobs by keeping Russian-linked enterprises in business.

Naturally, these trade ties are also easily used for negative linkage. The slightest foreign policy defiance can easily be punished through temporary "transportation delays" or "food safety issues" which cost the target state dearly. For example, when Lithuania hosted the November 2013 summit at which Ukraine, Georgia and Moldova were to sign EU Association Agreements, Moscow began a boycott of Lithuanian dairy products. Poland, a frequent critic of the Kremlin, was soon told its fruit was unwanted—an embargo eventually extended to the whole EU. Georgia had experienced similar treatment since 2004, when its then-president Mikhail Saakashvili began a series of disputes with Moscow. Georgia had long shipped most of its mineral water and wine to Moscow. Now, though, it was told its products were contaminated with chemicals and could not be sold. This embargo lasted until Saakashvili left office in 2013, and since then has been carefully ratcheted up or down depending on the behavior of his successor. As the EU has now discovered, perishable food products are a particularly good area for sudden Russian embargoes, since it is almost impossible to find alternate markets for Norwegian seafood or Greek fruit before they rot.

Finance and Investments

Under Putin, Russia was able to pay off its heavy debts to outside lenders and amass a large war chest from oil and gas sales. This wealth has enabled the country to use loans as an inducement in the "near abroad." For example, after Ukrainian President Yanukovych backed away from the EU, he was quickly rewarded by the Kremlin with the promise of $15 billion in loans. In the end, only the first $3 billion tranche was paid out before he was overthrown. In addition to outright government largesse, Moscow can also rely on a host of state-owned corporations to step forward with generous investment checks in friendly countries. In many cases such investments also create platforms for further Russian influence. For example, Rosneft and Gazprom have been working to buy up pipeline infrastructure and refineries in the "near abroad." This would clearly allow Russia to increase its already large energy leverage.

As in the other areas discussed here, such economic incentives can swiftly become sanctions if a country turns against the Kremlin. Moscow has made it clear that property rights have little meaning in today's Russia. The classic case of the dismantling of Yukos Oil is always instructive. Yet here too, as in other areas, Russian officials have become more refined. For example, they have worked for years to effectively nationalize Western oil holdings in Russia. Shell held a large stake in an offshore project near Sakhalin Island; it was harassed with "environmental complaints" and other legal hurdles until it sold to a Russian concern—at which time the obstacles suddenly vanished. Similarly, BP was harassed for years until it agreed to sell its 50 percent stake in the BP/TNK joint venture. When the West began to sanction Russia over the Ukrainian crisis, several McDonald's restaurants were suddenly closed for "food safety" reasons. And if a stronger signal is called for, foreign assets may simply be seized. Ukrainian President Poroshenko, known as the "chocolate king," saw his candy factory in Russia suddenly shuttered. And most recently, the Duma has been considering a law which would allow the government to seize some assets from any country which sanctions Russians as "compensation."

Migration Control

Yet another area which has often escaped notice from commentators is Russia's potential to control migration from ex-Soviet republics. Here too, compliant states can be rewarded and defiant ones punished. States which favor Moscow see their nationals permitted to enter Russia easily, work there with few obstacles, and send money home without problems. Yet when politics intervenes, migrants suddenly face hurdles. For example, Ukraine has historically had millions of its citizens working in Russia. One weapon that Moscow reportedly used to induce President Yanukovych to refuse to sign an EU Association Agreement was the threat of expelling these workers. Similarly, Georgia faced years of harassment of its workers in Russia when President Saakashvili began to defy the Kremlin. Some Georgians were simply rounded up, thrown onto military planes, and flown back to Tbilisi. Many more faced threats at workplaces, threats to expel their children from school, threats to deny visas, and threats to cut off remittances back to Georgia. Since payments from migrants in Russia make up a major portion of Georgia's GNP—as is the case for many poor states in the near abroad—such threats are a potent sanction.

Growing Russian Influence

Overall, it is clear that Moscow's economic grip in the "near abroad" has become much stronger in recent years—culminating in the current project for a Eurasian Union. Its influence reaches across many spheres of economic activity. And it can play out in either overt or subtle tactics, such as "food safety inspections," "routine visa checks," and "tax enforcement measures." These tactics can be seen as the economic equivalent of the "masked warfare" strategy which Russia has pursued in Crimea and the Donbass. Like those military measures, the

Kremlin's economic strategy often maintains a threadbare cover of legality or ambiguity, at least until firmer, more open measures are needed. Yet the message sent is clear: compliance is rewarded, defiance is punished.

About the Author

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Recommended Reading

- Goldman, Marshall I. 2008. *Petrostate: Putin, Power and the New Russia.* Oxford: Oxford University Press.
- Newnham, Randall E. 2011. "Oil, Carrots and Sticks: Russia's Energy Resources as a Foreign Policy Tool." *Journal of Eurasian Studies*, Vol. 2, No. 2, pp. 134–143.
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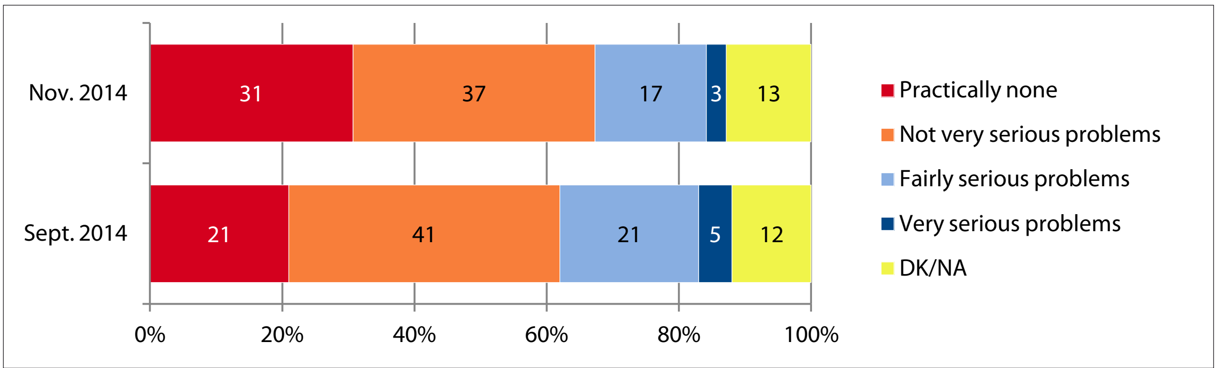
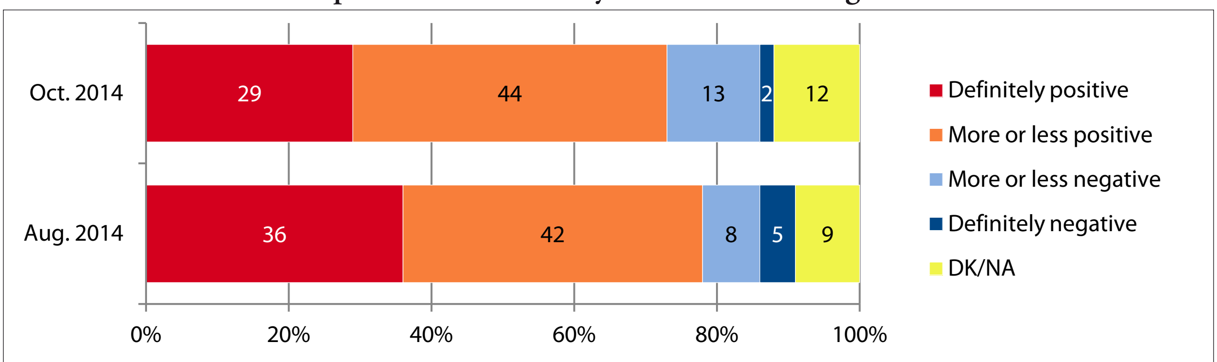
- Stulberg, Adam N. 2007. *Well-Oiled Diplomacy: Strategic Manipulation and Russia's Energy Statecraft in Eurasia.* Albany: SUNY Press.
- Van Herpen, Marcel H. 2014. *Putin's Wars: The Rise of Russia's New Imperialism.* Lanham, MD: Rowman and Littlefield.

Poll: What Do You Think, Could Your Family Have Problems in the Future Due to the Western Sanctions Against Russia?



Source: representative opinion poll by Levada Center, 14–17 November 2014, N = 1,600, <http://www.levada.ru/28-11-2014/vliyanie-sanktsii-na-potreblenie>

Poll: How Do You Feel About the Introduction of a Ban on the Import of Food and Agricultural Products from Countries of the European Union and the USA by the Leadership of Russia in Response to Sanctions by these Countries Against Russia?



Source: representative opinion poll by Levada Center, 24–27 October 2014, N = 1,630, <http://www.levada.ru/11-11-2014/kontrsanktsii-problemy-i-posledstviya>