INC SIM Investment & Networking Club
Research Department
Insights through research and analysis

RESEARCH INSIGHTS

Cheston Fong Shuan Rong
csrfong001@mymail.sim.edu.sg

Sanctions in contemporary times

Effective or Minor Inconvenience?

When Russia invaded Ukraine on 24 February 2022, the rest of the world swiftly condemned the invasion and began discussions on measures to punish the attack. As soon as the UN resolution to condemn the invasion was passed, sanctions began to be implemented. The anticipation everyone had was that such sanctions would cripple the Russian economy and force them to stop their actions. News constantly ran in the subsequent months that the Russian economy was on the brink of collapse, with its currency close to collapse and that people were not able to get necessities, seemingly evidence that the sanctions were working, and the conflict would be forced to end soon.

Nearing a year on from the time that article was written. The conflict is still ongoing with Russia showing little sign of damage on the surface. This begs the question- how effective are economic sanctions in our contemporary times.

Types of economic sanctions

Historically, there have been different types of economic sanctions imposed throughout the past century. The primary goal of sanctions is to hinder the ability of the country's economy to function normally by either disrupting the ability for them to conduct business or hindering their access to important resources.

First - Trade Embargoes. This is where the initiating country enacts legal barriers to prevent trade with the targeted country. It could be a general embargo where all trade is prohibited to more selective embargoes where certain products or services are prohibited. Examples of an embargo are the US embargo on Cuba, which is a general embargo prohibiting US businesses and citizens, and the OPEC oil embargo in 1971 which prohibited the sale of oil from Arabic members to countries that supported Israel.

Secondly - Sanctions. It is similar to embargoes in that both are legal barriers to trade implemented by countries on their own citizens. However, they are usually less severe in terms of scope, severity and diplomatic perception. Sanctions are typically targeted at specific industries, products, or even individual people. Examples are 1992 Arms sanctions on Somalia by the UN, Australia's live cattle sanction on Indonesia in 2011 and the various sanctions on the Belarusian President, Viktor Lukashenko, ranging from travel bans, assets freeze in complying nations to bans on providing loans to him.

Thirdly - Tariff discrimination is where a country passes extra tariffs on particular goods or services to discourage trade between the targeted country and themselves. Recent examples include the US tariffs on Canadian steel and Chinese goods during the Trump administration. A 25% tariff on all Chinese products were passed due to political perception of intellectual property thief and a worsening trade deficit. Said tariffs resulted in retaliatory tariffs on US goods by China in response to the announcement.

Fourthly - Freezing of assets is where the host country disallows the use or withdrawal of assets that the foreign nation or person owns in their county. Assets frozen may eventually be sold off as further penalties or seized for use in other projects. It is typically targeted at specific individuals, although assets belonging to nations has been frozen like Iran and Afghanistan assets held in the United States.

Fifthly - Capital flow restraints are measures to block or hinder the ability of individuals or nations to transfer financial assets for transactions or payments. By hindering the speed in which transactions are done, it slows down business activity and increases the costs of transactions.

Sanctions placed in response to the 2022 Invasion of Ukraine

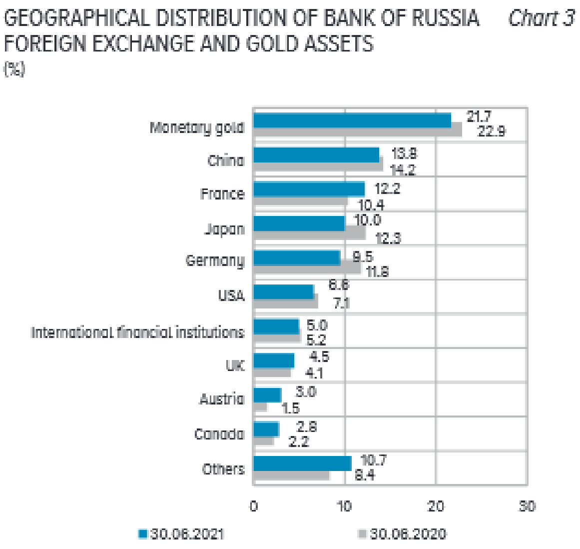
Before 2022, several sanctions were already in effect in response to the annexation of Crimea, a region of Ukraine, in 2014. These were mainly targeted sanctions aimed at officials in the Russian and Crimean authorities and were mainly travel bans, freezing of assets and denial of financial services to restrain capital flow. An embargo of military equipment as well as financial services sanctions to two of Russia's major banks and their energy firms. Export controls were also imposed on equipment primary used in the oil industry.

When the invasion occurred, Western nations quickly condemned the invasion and began implementing more economic sanctions. Besides aid varying from military equipment, monetary financing and humanitarian aid, they have also implemented new sanctions that were more broad and harsher than the 2014 sanctions.
Amongst the new sanctions, there was the freezing of the country foreign currency assets located in other countries, disallowing financial services to the country, restrictions on Russian banks from the global financial payment system (SWIFT) excluding transactions for energy and the selected seizures of assets belonging to influential people in the Russian society.

Subsequent economic sanctions include export controls on equipment and technology sourced from the United States. An important result of this export controls initiated by the US is that South Korea and Taiwan semiconductor manufacturers began to ban exporting their products.
Measures to target the key drivers of Russian economy were also implemented. European countries in particular, aimed to reduce their imports of Russian hydrocarbons and began constructing infrastructure to improve their energy imports from other countries like Liquified Natural Gas Terminals. Nearing December, a G7-discussed price cap of Russian oil was discussed and went into effect in Dec 22 that aimed to set the price cap at $60 per barrel.

Impact of Russian sanctions

Pre 2022, Russia has continuously built up a sizable gold and foreign currency reserve in an attempt to de-dollarize their economy to reduce their vulnerability to sanctions. It was expected that they would use their 585 billion USD worth of reserve to cushion the impact of their economy against sanctions. However, within a few days, the US and its allies froze Russian foreign reserves that were in their countries. This move reduced their reserves by 48.6% of their total reserve as of their 2021 breakdown of their reserves. These reserves are typically used in monetary policy or for use in settling foreign transactions. So, when sanctions were passed, demand for the Russian ruble expectedly decreased as European countries reduced a majority of their Russian imports. Without the reserves in foreign currency to maintain a stable currency via open market operations by the central bank, the currency depreciated from 84.91 to 133.46 ruble to 1 USD in Mar 7. To prop up their currency, the Russian central bank intervened to restore the ruble by introducing capital controls to limit the flow of foreign currency out of the country. Coupled with interest rates as high as 20%. These measures worked and by March, the currency recovered.



As the import bans of Russian hydrocarbons went into effect. European countries had to quickly source alternatives for their economies. While some measures were taken such as the reinstating of coal power plants, it is simply impossible make sweeping changes in a country's infrastructure at such notice. Hence, most of the effort to make up for the shortfall in hydrocarbons from Russia was to source it from other countries. With the goal to fill their reserves before the incoming winter, demand for oil and gas quickly increased across the world as countries boycotting Russian oil and gas tried and outbid each other. This resulted in prices going from $96.84 a barrel to a high of $123.31 with prices returning to prewar levels only in September. Furthermore, some European countries in the EU which previously were the biggest importers of Russian oil and gas, still had to continue imports or they would risk their economies otherwise. Other countries that were not participating in sanctions also increased their imports to take advantage of the discounts that Russian producers were offering to attract buyers. This increase in oil prices combined with only a 15% decrease in export volume resulted in that Russia was still able to make 60% more profit when looking at a year period from May 2021 to May 2022 according to the Center for Research on Energy and Clean Air, a research organization.

A side effect of the oil price increases was causing an energy shock globally. With high oil prices, it caused prices of most goods to increase globally, causing inflation globally. In Russia, the CPI increased by 12% according to the central bank. Combined with the sanctions reducing their other exports, the Russian economy is expected to shrink by 2.3% according to the IMF.

The ban on exports to Russia are mainly export controls of US goods, services and technologies. This in effect ranges from machinery parts for planes, oil equipment and high-tech semiconductors being banned from export to Russia. Even though the US does not directly provide these goods and services, countries that are diplomatically allied to the US or already sanctioning Russia directly, have tended to announce their intention to follow US guidelines. For example, TSMC, a semiconductor manufacturer based in Taiwan and Samsung which is based in South Korea announced shortly after the Feb 24 announcement of US export controls of their intention to ban sales to Russia. According to OEC data in 2020, imports of machinery, vehicles and chemical products make up the 3 biggest components of Russian imports. The export controls imposed thus directly affected Russian imports of machinery and vehicles, which resulted in parts shortages for repair and maintenance. News of such effects occurred as early as beginning March for their automobile industry, their oil industry by March's end and their aviation sector in August.

Removal of Russian banks from the SWIFT financial payment systems as well as banking restrictions are capital flow restraints aimed to make the process of transactions difficult and tedious. The SWIFT financial system refers to the communications network that banks and financial institutions globally use to submit payment instructions and information using a standardized format. The system is a secured network in which only verified users with the correct login details can use, this helps to verify the authenticity of transactions and reduce the time it takes to carry out transactions. By removing Russian banks from the system, it makes it difficult for the banks to process payments for trade and financial obligations as banks would have to resort to older methods or longer communication channels to conduct payment instructions. This delay and difficulty of conducting payment is to discourage businesses from conducting transactions with Russia to reduce the quantity of imports as transaction costs increase. Another side effect of such sanctions is the impact of slowing transactions in a high-speed financial system, which disrupts the bank's own trading activities.

Notably because of this measure, it resulted in a debt default on Jun 27 as the US refused to renew a license on 25 May that gave them an exception that allowed Russia initially to use their frozen reserves to repay interest on their bonds. When the due date of their next payment came, they were unable to repay their interest payments which resulted in credit agencies declaring a default. With the default, it caused investors to be wary of loaning funds to Russia, requiring Russia to offer higher interest rates, reducing the funding they could acquire.

Measures taken to circumvent sanctions

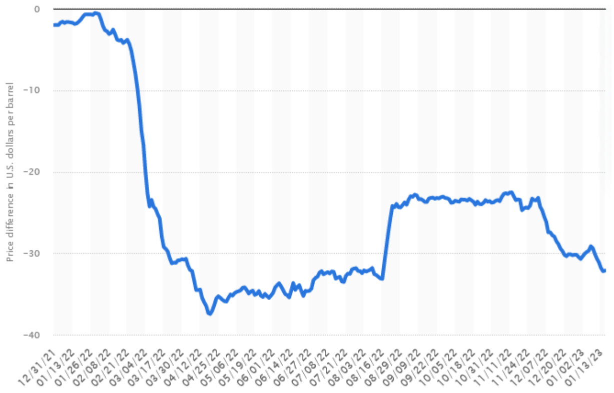
In the lead up to the 2022 invasion, measures were taken to reduce possible effects of sanctions.

The Russian's foreign reserves which they had slowly built up since 2014 was worth 585 billion USD in 2021. While 48.6% of their reserves was estimated to be frozen when new sanctions were implemented, their reserves in China which account for 13.8% of their total reserves was not frozen, and they hold 21.8% of their reserves in physical gold that is stored in their own country. This allows them to still pay for transactions with non-sanctioning buyers when the sanctions hit.

Furthermore, to acquire more foreign currencies for use once sanctions were imposed, Russia mandated that their gas companies only accept payments in Rubles. This measure helps to maintain the demand for the currency, hence to reduce its devaluation. As of 30 Dec, it is currently 73.75 Ruble to 1 USD which is close to its prewar value of 77.74 Ruble on 18 Feb.

To get around the possibility of being banned from the SWIFT network, the Russian Central Bank developed an alternative, SPFS, in response to threats of disconnection back in 2014. SPFS is another communications system similar to SWIFT in terms of use. In March 2022, it was announced that the central banks of China and Russia would co-operate, and to integrate their transaction systems. However, despite growth in users of the network, SPFS has not been able to compensate for the loss of access to the SWIFT network, possibly due to the lack of adoption in countries that are more closely aligned with the US or European countries.

To circumvent the loss in sale of exports to the European countries post 2022 sanctions, Russian exporters have been offering discounts for their products. Pre-invasion, Urals oil would trade at around $5 discount to the Brent oil prices as a benchmark. Post sanctions, it was discounted in ranges from $22.54 to $37.47. Non-sanction buyers hence are taking advantage of the discounted prices to avoid buying the higher priced un-sanctioned oil that sanctioning countries are purchasing. India and China have notably increased their exports of oil and gas in response to higher oil prices. As stated previously, this has not only helped to offset Russia's loss of European importers but let them gain a net profit as well as a source of foreign currency in which to import necessary goods. Another point of note is of speculation that European oil importers have been indirectly purchasing Russian oil via purchasing from India refineries owning to India's oil exports increasing.



The export controls on technology, goods and services are Trade embargo of foreign technologies. The 2020 OEC data shows that Russia's main exports are raw minerals, processed metals and precious metals with their main imports mainly machinery and transport. This suggests that they have a reliance of foreign goods and technologies which are involved in their industry of resource extraction. While as of the time of writing the 2022 OEC data has not been made available, news of equipment parts shortages, cannibalism of parts from unused aircrafts has appeared throughout the 2022. Which suggests that these trade embargoes are having an effect. However, not all countries who trade with Russia are participating in sanctions. This allows Russia to acquire some foreign goods that it requires via trading with these countries. An example of circumventing the embargo is related to missile components. Russia is reliant on foreign imports of high-tech computer components for manufacturing of their advanced weapons due to their lack of an advanced semiconductor industry. Independent analysis of computer components that were recovered from missile strikes conducted in end November 2022 had concluded that the missiles used were manufactured between September to November. The times of manufacture are past the date where sanctions were passed, which suggests that they were able to acquire the high-tech parts needed for their advanced weapons despite the sanctions.

Writer's Opinions

Sanctions historically in the age of empires had little impact owing to nations being less reliant on each other and had little demand for specialized products. But in our modern globalized economies, countries specialize in different products for exports to others due to inherent advantages that they may have for their specialization. While this efficiency allows for more goods for all countries, it also makes a country reliant on others for the goods and services they lack. This interdependence on each other is what economic sanctions can block, and what I agree that makes them effective.

However, sanctions are reliant on compliance of the countries sanctioning and the number of countries sanctioning. If the country being sanctioned has unsanctioned allies that continue to trade with them, they can then rely on their allies to still get access to goods and services that they need. However, this as well as other methods to circumvent sanctions have a long-term cost. Depending on their methods and allies' commitment to their cause, the cost of sanction circumvention is only going to increase in the long term. For instance, countries that do trade with a sanctioned country know that they are in a position to bargain for higher prices for themselves due to the risks involved in helping to circumvent sanctions. This means for the sanctioned country; they incur a higher cost of acquiring the same material. In the short term, a country can rely on their stored reserves of funds to pay for the needed material. But once the reserves run out, the country will have to resort to increasingly costly measures to fund their material needs. These costly measures to raise funds can begin from as simple as raising interest rates on their bond offerings. Subsequently, it can be encouraging citizens to voluntary or mandated to purchase government bonds and selling government assets off. Eventually once the previous measures are insufficient, dire measures may be implemented like creating money out of nothing which would result in high inflation to nationalizing private assets for sale. All these measures can damage a country's business environment and economy in the long term.

Thus, I argue that in response to the sanctions seemingly having little effect on Russia over the past year, that the sanctions have not had time to set in. Seeing that Russia has spent nearly a decade preparing for potential sanctions, their ability to continue unaffected is primarily due to their preparations like their large reserves. Given enough time and more sanctions to hinder methods of circumvention or measure to ensure compliance of both sanction and non-sanctioning parties, I feel that the economic pressures would eventually be too much for the country to be able to maintain its current standards of living and ability to wage a modern war. That is unless the country collectively agrees to accept the possible conversion to a war-time economy and forgo their long-term growth prospects.

Disclaimer

Any names of financial assets listed during the sessions are for educational purposes only. It is not an offer to solicit any buying or selling of shares. Any recommended trades or investment undertaken will be of your own responsibility and will have nothing to do with SIM Group, SIM-INC, or any of the members from the Market Research Department. We are not a licensed trader or remisier and are therefore not allowed to make any buy or sell calls in relation to and financial asset. If you wish to invest or trade, please consult your licensed remisier or broker. Any names of companies listed here are not an advertorial of the group's products or services and solely for educational purposes only. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. We believe the information provided here is reliable, but do not warrant its accuracy or completeness. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The views and strategies described may not be suitable for all investors. This material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for, accounting, legal or tax advice. References to future returns are not promises or even estimates of actual returns a client portfolio may achieve. Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation.