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Sanctions Hurt Putin's Hold on Power

By Sergey Guriyev

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Many critics argue that the sanctions imposed on Russia for its actions in Ukraine are ineffective because they are too limited in scale and scope. Moreover, sanctions are seen as allowing President Vladimir Putin to blame the West for Russia's internal problems. Indeed, some of Putin's supporters within Russia welcome the sanctions as a means to compel Russian autarky — and thus strategic independence from the West.

These arguments are wrong. Though the sanctions are not backed by China, they are already having a powerful effect, and the expectation that they will be tightened further is a huge concern for investors and the Russian government. Full autarky, meanwhile, would imply a dramatic decline in Russian living standards — the foundation of Putin's domestic support.

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The latest sanctions are unprecedented. The European Union went even further than the United States. Exposure to Russian markets varies widely among EU countries and even more greatly between the EU and the U.S. But after the downing of Malaysia Airlines Flight MH17, Russia can no longer pursue a divide-and-rule strategy that leverages these differences.

Both the EU and the U.S. have now sanctioned Russia's highest officials and leading companies and banks. The EU list includes all of the main state-owned banks (the country's largest). Most important, the EU added Sberbank, a cornerstone of Russia's financial system, with assets totaling almost 30 percent of Russian GDP and about half of Russian retail deposits.

Currently, the sanctions only limit Sberbank's access to European capital markets. In the immediate future, Sberbank — and other sanctioned banks — will be able to replace European funds with liquidity provided by Russia's Central Bank or Asian sources. But the fact that Sberbank is on the list has created enormous anxiety for all foreign investors in Russia.

They are right to be worried; Russia's financial system is highly vulnerable. The banking sector's total external debt is $214 billion, of which $107 billion is due within a year (and $129 billion within two years). Non-financial firms' external debt totals $432 billion, with $128 billion due within a year (and $175 billion within two years). These are large numbers even for Russia, with its currency reserves of $480 billion.

Likewise, though the ban on exports to Russia of technology for the oil and gas sector holds no immediate implications for the Russian economy, over the course of the next few years, Russia will have to use Western technology to develop new oil fields. Otherwise, its oil output will stagnate or even fall, hitting the ruble and living standards hard.

Financial markets and Russia's government understand the gravity of the medium-term risks. To avoid ruble depreciation and inflationary pressure, the Central Bank raised its benchmark interest rate to 8 percent (from 5.5 percent before the Crimea crisis). But this may not be enough, given that Russia's recently introduced embargo of food imports from the EU and the U.S. will contribute significantly to price growth.

Since January, Russian stocks have lost 16 percent of their value on the MSCI index, after already trading at a 50 percent discount in 2013, while Brazilian and Turkish equities are up by 13 percent and 27 percent, respectively. With MSCI now set to offer investors emerging-market indexes that exclude Russia, a massive sell-off of Russian stocks by index funds will drive down prices further. Indeed, the net capital outflow is expected to grow from $60 billion last year to at least $100 billion dollars this year, with some estimates as high as $200 billion.

One consequence of all of this is that the government can no longer balance its books and has started to discuss spending cuts and new taxes, in particular a sales tax. Over the last 10 years, the question has been whether to keep the existing 18 percent value-added tax or replace it with a sales tax. Now the debate is whether to introduce a sales tax on top of the VAT or to raise the VAT rate.

In addition, Finance Minister Anton Siluanov has said that the government must use this year's pension contributions for projects in Crimea, while some highway construction has been postponed indefinitely. The government now says that it will expropriate next year's

pension contributions as well. In a leaked letter, Deputy Prime Minister Arkady Dvorkovich explicitly acknowledged to Prime Minister Dmitry Medvedev the impossibility of fulfilling Putin's spending promises, and proposed a radical revision of current fiscal plans.

Importantly, though, Putin's popularity rests on historically high living standards. Annual household consumption is now double the level achieved in the Soviet Union's dying days. Consumption growth has been driven largely by Russia's integration into the global economy — and cannot be sustained without it.

The last generation of Soviet leaders well understood the importance of maintaining living standards, which is why they used revenues from oil and gas exports to import consumer goods. When oil prices collapsed in the mid-1980s, household consumption collapsed; soon after, so did the Soviet Union.

Today, though oil prices remain high, Russia's budget and financial system face severe problems over the next two to three years. If the West introduces full-blown sanctions against the largest Russian banks — as the U.S. has already done against relatively small banks — those problems may become insurmountable.

How will Russia's government respond? Putin cannot afford to hand back Crimea, which would be viewed domestically as a major political defeat. This implies that sanctions will remain in place. But having already deployed political repression, censorship and propaganda, Putin's tools for maintaining control as Russians' living standards decline will be limited. The nature of that dilemma makes it impossible to predict what he will do next.

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