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TENSION AT THE TOP

The Impact of Sanctions on Russia's Poles of Power

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The Issue

To what extent are Western sanctions on Russia impacting the Putin regime? Evidence suggests that economic sanctions are fostering a divide between (1) the groups that profit from Western money (Russia's "oligarchs"), and (2) those who wield state power and/or profit from the domestic budget (Russia's *siloviki*). Two previous rounds of financial sanctions – credit freezes and the latest addition of several large companies to the U.S. Treasury's list of "Specially Designated Nationals" (SDN) – appear to be straining the relationship between the oligarchs and the *siloviki* because of the strong impact these measures have on the Russian economy. For now, what is unclear is whether this tension at the top of Russian society will translate into a substantive policy change from the Kremlin.

Russia's Two Elites: The *Siloviki* and the Oligarchs

Scholars often describe today's Russian ruling establishment as roughly combining two types of elites. The first are the *siloviki*: individuals with an ex-KGB background, those in Putin's inner circle, and old Ozero cooperative friends.[1] The second: the public-private oligarchy comprised of business groups that control Russia's largest companies.[2] When ex-KGB officer Vladimir Putin came to power back in 2000, he made a deal with the 1990s-era oligarchs: "We of the *siloviki* will run the country, and you oligarchs can keep your ill-gotten gains if you are loyal and share your profits."[3] While the oligarchs are primarily interested in increasing their personal wealth, the *siloviki* are also at least partly motivated by the geopolitical goal of reestablishing Russia's status as a Great Power in world affairs. For years, this arrangement worked; and its distinctions were a helpful shorthand for distinguishing between the different nodes of power inside of Russia. However, today it is more useful to describe these two groups as comprising the elites who 1) make money domestically and/or head state-owned corporations (approximated as the *siloviki*), versus 2) those elites who profit from Western money (the oligarchs).[4]

The sustainability of this arrangement between the *siloviki* and the oligarchs historically relied on a growing Russian economy. Financial affluence compensated the oligarchs for any economic losses brought about by state policy. If Putin's anti-Western geopolitical posture was the action, then subsequent Western sanctions (U.S. and EU combined) against Russia were a reaction. In the West, sanctions were designed to raise the costs of Russian strategic behavior and – ultimately – change the Kremlin's foreign policy. If Western penalties on Russia's current policy track are high enough, then will the Kremlin find incentives to change course? Likewise, will a stagnating Russian economy prompt a struggle between the oligarchs and *siloviki* inside of Russia – one that breaks their earlier arrangements?[5,6] The implications of this break could significantly alter Russia's strategic behavior to date.

> "Today it is more useful to describe **these two groups as** *compromising the elites who* 1) make money domestically versus **2) those who profit from Western money.**"

Understanding the Russian Sanctions

In order to answer these questions, one needs to take a closer look at the specific types of sanctions and their impact on

Russia's economy and politics under both the Obama and Trump administrations. It is important to consider the history of the sanctions and how they work. To do this, it is useful to divide the sanctions on Russia into three groups – individual, sectoral (e.g., energy and defense), and financial sanctions.

The first group – the individual sanctions – directly imposed asset freezes and/or visa bans on specific persons considered to be acting for or on behalf of the Russian government. Michael Carpenter, former Deputy Assistant Secretary of Defense for Russia, argues that the Obama administration at first targeted the narrow group of people inside Putin's inner circle, but not the wider concentric rings of oligarchs that make up the constellation of economic power in Russia. This made those sanctions ineffective in fostering splits among Russian elites. Among the ruling elites, even the most outspoken pro-Western group (*e.g.*, Anatoly Chubais, Elvira Nabiullina, Alexei Ulyukaev, and others) – did not show any signs of disagreement with the Kremlin policy; and none of them became proponents of top-to-bottom political change.[7] This suggests that the very concept of more liberal (*i.e.*, systemic liberals) and less liberal factions composing the Kremlin's top political ruling group is now outdated.

The second group – sectoral sanctions on the energy and defense industries – includes bans on the export of equipment and provision of certain services to specific companies in the Russian energy industry, as well as a prohibition on certain arms exports.[8] Energy experts have expressed skepticism regarding the ability of sectoral sanctions to seriously impact Russia's policy in the near future. For example, Vladimir Milov, former Russian Deputy Energy Minister, has argued that such sanctions could only be considered a *longer-term* limit on Russian behavior. New extraction technologies are costly; and their

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introduction becomes economically efficient only when oil prices reach the $150-200 per barrel mark. Today, prices are a long way from that point.[9] A recent report by the Skolkovo Management School Energy Center has also concluded that, under the current sanction regime, the availability of technologies and investments will not become a significant constraint to Russia's energy industry until at least 2020.[10] This is due to the exploitation of preexisting hydrocarbon deposits and energy investments. Hence, in the short term, the impact of sanctions on Russian energy production is exceptionally limited. In the *medium term* (until 2025), even tighter access to new technology will not dramatically reduce Russia's volume of oil production, for example. Indeed, the serious effects of these limitations are unlikely to be felt until 2030.[11] Therefore, while the existing sectoral sanctions may be considered a longer-term constraint on Russia's economy, they are unlikely to significantly impact the Kremlin's calculus in the short term.

The third group – financial sanctions – so far has proven to be most painful for Russia's economy. The financial sanctions can be subdivided into two groups. The first round, imposed in 2014, included the suspension of preferential economic development loans to Russia by the European Bank for Reconstruction and Development (EBRD), a ban on trading bonds and equities, and a ban on loans with maturity periods exceeding thirty days for some of Russia's biggest banks and companies.[12] Although only very few (mainly state-owned) Russian banks and companies were directly sanctioned, the novelty of this new sanction regime and related uncertainty led Western creditors to avoid long-term operations with some major Russian counterparties.[13] Until around mid-2016, few Russian banks and companies were able to raise funds in Western capital markets. In May 2016, Russia's government itself failed to place its Eurobonds on Western markets, since U.S. and European banks refused to cooperate.[14] This had a serious impact on Russia's economy, which historically relied on access to Western capital markets for credit. In this case, sanctions led to a dramatic increase in the volume of foreign loan repayments in late 2014 and early 2015 and contributed to a collapse of the ruble in mid-December 2014.[15] The decline in the inflows of foreign direct investment and deterioration of funding conditions also affected non-sanctioned companies.

> *"The very concept of more liberal* **and less liberal factions** composing the Kremlin's **top political ruling group** *has now become outdated."*

One scholarly assessment estimated that Russia's GDP fell by as much as 2.4 percent by 2017 because of these sanctions.[16]

Yet, by fall 2016, the *de facto* freeze on Russian credit operations dissipated. Western creditors slowly adjusted their approach by avoiding cooperation with only Russian persons and companies who were directly targeted by sanctions. Since September 2016, the Russian government and companies have effectively regained access to Western financial markets.[17] As a result, the Western IPO market became available – once more – to Russian companies in 2017.[18] This significantly decreased the impact of financial sanctions that were imposed on Russia's economy.

The second round of financial sanctions, those specifically designed to punish Russia for its foreign election meddling and aggression toward its neighbors, were deployed in April 2018.[19] These sanctions targeted seven Russian oligarchs and 12 companies those oligarchs owned or controlled, plus 17 senior Russian government officials, and a state-owned Russian weapons trading company and its subsidary, a Russian bank. The new sanctions froze the U.S. assets of these individuals and companies and forbade Americans in general from doing business with them.[20] For example, the sanctions made it very difficult for Rusal, the world's largest aluminum producer (supplying 7 percent of world supply), and the company's head, tycoon Oleg Deripaska, to do business in dollars.[21] It also paralyzed Rusal's supply chain.[22] As a result, Russia's main share index crashed by 11 percent and the ruble plunged.[23,24] While this was a major event for the Russian economy, observers grappled to understand the underlying logic for why some specific individuals were included on the sanctions list, and others were not. Overall, this contributed to rising unease among Russia's oligarchs.

The Oligarchs' Dissatisfaction

Prior to April 2018, there were multiple accounts of rising Russian business anxiety due to the upcoming package of new sanctions. This manifested in increased anti-sanction lobbying in Western countries, asset sales, and re-registration of oligarch assets under the names of relatives.[25] When the April sanctions package eventually did hit, there were accounts that the oligarchs' dissatisfaction with Kremlin policies had increased. Along with lobbying for state support and credits to compensate for sanctions-induced financial losses, businessmen also expressed hopes at a series of meetings with Putin (and other officials) that Moscow's relationship with the West would improve. In his interview with CNBC in late May, Andrey Kostin, president of Russia's large government-related VTB bank, revealed that he advised the Kremlin against symmetric responses to the U.S. sanctions: "I'm telling my government, actually advising my government not to take any tit-for-tat actions, frankly speaking, because I think somewhere we should stop this tit-for-tat."[26] Kostin's comment, which likely reflected his clients' views, is indicative of the pressure that big business and the oligarchs were exerting on the Kremlin. The goal: prevent further escalation of Western sanctions.

Rising pressure at the top may have affected a shift in the Kremlin's rhetoric.[27] In the hope of alleviating sanctions following the April round of sanctions, the Kremlin reportedly ordered officials to curb their anti-U.S. rhetoric.[28] In the past, Kremlin officials tended to claim that the sanctions did not bother them much and, if anything, stimulated Russia's domestic industries. After the April round, however,

they dramatically scaled down aggressive anti-Western rhetoric. The tone changed further at the St. Petersburg Economic Forum in late May. Putin and other officials, such as Minister of Finance Anton Siluanov, started describing sanctions as being "harmful to everybody" and expressing hopes for their gradual removal.[29,30] Change was occurring.

> "***Rising pressure*** at the top may *have affected a shift in* **Kremlin rhetoric**."

However unhappy with Kremlin policy the Russian oligarchs may be, so far, their ability to veto extreme decisions is limited at best, and they only appear to slightly adjust rather than substantially influence Russia's foreign policy. For example, the business community reportedly lobbied against a draft bill under consideration by the Duma, which would have imposed criminal liability for complying with Western sanctions.[31] Under pressure, the Duma eventually had to rework the bill to make the wording less radical.[32,33] The new version replaced the punishment for compliance with Western sanctions from a criminal to administrative prosecution — a distinction under Russian law.[34,35] The bill has not yet been approved. In late May, the Duma did pass a revised version of a bill on counter-sanctions. This was designed as Russia's response to the April sanctions. Significantly, the original version of this bill included drastic bans on numerous imported goods. It even imposed restrictions on the ability of foreign specialists to work in Russia. Once again, following criticism and lobbying by business and expert groups, Duma deputies substantively revised the document. They employed more generalized language, excluding clauses that allowed for bans on goods like medicine, tobacco, alcohol, and foodstuffs.[36,37]

While the Russian economy is demonstrating short- and medium-term flexibility in the face of Western sanctions, the real strain on the country's prospects will come over the long term. That said, the sanctions regime does appear to be taking a toll in the short term, at least in some quarters. Recently, a report by Russia's Higher School of Economics estimates that the April sanctions would drastically increase capital outflows, act as a drag on Russia's already sluggish economic growth, and foster isolation and technological backwardness in the Russian economy.[38] After allegedly coming under pressure from the FSB, the school withdrew the report from the web. But the point stands. Even Russia's Central Bank-sponsored Analytical Credit Ratings Agency recently named the possibility of more Western sanctions against Moscow as the key risk for the Russian economy.[39] Additionally, sanctions are already hitting companies operating in Russia's hinterlands, where the largest sanctioned companies typically operate. For example, Rusal (noted earlier) was recently forced to freeze its $24 million budget allocated for utilities in Russia's cities, such as Sayanogorskg.[40] Meanwhile, the risks

of rising unemployment and social protests are on the rise in cities whose budgets depend on sanctioned companies. And at the national level, concerns about the future sustainability of Russia's budget recently prompted the Kremlin to announce increases in the VAT and retirement age.[41] These financial "reforms" provoked mass dissatisfaction, social protests, and a dramatic decline of governmental approval ratings (including Putin's own).[42]

Kremlin concerns about the sanctions have manifested themselves in different ways. The move to prosecute complicity with Western sanctions (noted earlier) is one such indicator. It is part of a wider effort aimed at signaling to elites that breaking with the government will not be tolerated. Kirill Rogov, a Russian political analyst, suggests that the multiplying number of counter-elite repressions (*e.g.*, criminal cases and arrests) at the federal and regional level are indicative of this move. The repressiveness of the Kremlin's domestic policy is growing in parallel to rising elite dissatisfaction. This discontent has yet to spill out into the open.[43] The internal bulwarks of elite repression are holding — for now.

The *Siloviki* Respond

Where does this leave the *siloviki*? While Russian businesses, which are integrated into the world economy, oppose a tightening of the sanctions regime, the *siloviki* do not favor improving relations with the West.[44] Andrey Movchan, a senior fellow at the Carnegie Moscow Center, argues that the real pressure comes from the members of Putin's inner circle who view Western sanctions as an opportunity. Sanctions allow those who are close to Putin to lobby for more attractive state-sponsored projects and contracts as a fee for their loyalty; while domestic businesses are lobbying for counter-sanctions that would advantage their financial interests.[45] In this way, anti-Western rhetoric has itself become a lobbying tool. Elites who express more "patriotic" (*i.e.*, anti-Western) sentiments can frame their own projects in such terms.[46] This improves the odds of gaining access to government largesse. Rogov points out that elites with mobile capital and better access to Western markets are more vulnerable to Western sanctions and have been weakened politically since 2014. Consequently, their dependence on Putin has grown. By contrast, the influence of anti-Western elites with immobile capital inside of Russia has been increasing accordingly. The *siloviki* have used Russia's tensions with the West to consume an ever-greater share of the national budget.[47] At the top of Russia's power structure, Western sanctions have therefore been an opportunity for some and weakened others.

> "***Kremlin concerns about the sanctions*** manifest in **different ways**."

Going forward, one key question for Western policymakers to consider: What are the actual tools that oligarchs might use to force positive change inside of Russia? As of now, the answer is not straightforward, nor is it

clear that the oligarchs are "winning" against the *siloviki*. Sanctions are more harmful to the oligarchs in the short term. In the long term, the risk of rising social instability caused by sanctions may become more dangerous to the *siloviki* as well. It remains to be seen whether the policy-making mechanism in Putin's Russia is flexible enough to incorporate and respond to pressure from the oligarchs.

Conclusion

Overall, the balance of evidence suggests that Western sanctions are already impacting Russia's political and economic situation. The effect will be even stronger if more rounds of sanctions, like the ones introduced in April, are implemented. This judgment, however, is complicated by the fact that many experts disagree dramatically in their interpretations of how Russia's political system works under Putin; and the intended impact of Western sanctions. So far, few attempts to systematically evaluate the sanctions issue have been made. Even a comprehensive list of the sanctions imposed on Russia over the course of the last four years does not exist. Rather, it must be compiled from various sources. Hence, it should come as no surprise that experts have yet to achieve a consensus on the topic. Nonetheless, a few preliminary conclusions about the future impact of sanctions can be drawn. Contrary to some accounts, Western sanctions do not seem to be fostering a political consolidation of oligarchs around Putin; even

Russian Federation President Vladimir Putin with Foreign Intelligence Service Director Mikhail Fradkov and Federal Security Service Director Alexander Bortnikov. Photo Credit: kremlin.ru.

if sanctions do not immediately lead to visible elite splits either. Instead, sanctions seem to be slowly but steadily putting a strain on the oligarchs' relationship with both the *siloviki* and Putin. The bad news here is that oligarchs have few direct mechanisms to affect meaningful and substantive policy change inside of Russia.

The larger issue is one of action, reaction, and cost. In previous years, the Kremlin's strategic behavior (action) incurred relatively low costs (reaction) from the West. This began to change after the illegal annexation of Crimea in 2014. Today's sanctions will bite hardest over the long term. In the near-term, the Russian government must now account for the possibility that the West will impose even higher costs on future (disruptive) actions. This represents a new "cost" factor for Russian strategic behavior. Putin may be willing to pay these costs. The poles of power around him may not.

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