Briefing
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Economic impact on the EU of sanctions over Ukraine conflict

SUMMARY

Russia is the European Union's third-biggest trading partner. In 2014, trade volume between the European Union (EU) and Russia decreased, mainly due to the impact of the recession on the Russian economy, as well as the conflict in Ukraine which led to EU sanctions and Russian countermeasures.

Beginning in early 2014, the EU introduced and extended a range of diplomatic and economic sanctions against the Russian Federation in protest at Russian involvement in destabilising Ukraine and violation of Ukraine's territorial integrity. Russia has retaliated with an embargo on certain EU agricultural products. The EU's economic sanctions will be in place until at least January 2016, while the Russian measures have been extended until June 2016.

It is hard to disentangle the effects of these sanctions from those stemming from the deteriorating economic situation in Russia. Although the overall impact on the EU economy has been rather limited, certain sectors and countries are more significantly affected. Estimates of the impact vary, but indicate overall that the European economy is resilient to the adverse effects of falling trade with Russia. Importantly, the EU's financial sector is not considered to be systemically threatened by its exposure.

The most visible direct effect is the substantial fall in EU agri-food exports to Russia. The losses are, however, mitigated to a large extent by redirecting exports to alternative markets.

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EU-Russia trade

Trade between the European Union (EU) and the Russian Federation is governed by a Partnership and Cooperation Agreement, which came into force on 1 December 1997 and is renewed annually since 2007. Talks on a new agreement were suspended by the European Council in March 2014.

Russia ranks as the EU's third trading partner (representing 8.4% of total trade) and the EU is Russia's biggest trading partner (with as much as 48% of total Russian foreign trade) and its most important foreign investor (up to 75% of foreign direct investment comes from the EU). The main EU exports to Russia are machinery, transport equipment (cars), chemicals, medicines, electrical and electronic goods and agricultural products (total value amounted to €103 billion in 2014). Russian exports to the EU are dominated by mineral fuels (74.9%), which contribute to a substantial Russian trade surplus (total value of exports to the EU amounted to €182 billion in 2014). Trade in services represents about 12% of total EU-Russia trade.

Figure 1 – EU exports to Russia in € billion

Data source: European Commission, DG Trade, 2015.

Trade between the two economies grew steadily until mid-2008, when the trend was reversed, mainly due to the economic crisis, which had a negative impact on trade volumes. Growth returned in 2010, reaching record levels in 2012. In 2014, the EU's exports of goods to Russia fell by 12.1%, whereas imports from Russia fell by 13.5%. Factors behind the decline include conflict in Ukraine, long-standing trade barriers, EU sanctions and Russian counter-sanctions, and recession[1] in Russia. Total trade value subsequently fell from €326 billion to €285 billion in 2014.

EU sanctions

The EU is closely monitoring the events unfolding in Ukraine, such as the protests in Kyiv, the annexation of Crimea and Sevastopol by Russia, the MH17 aircraft disaster, and the so-called hybrid war. The European Council considers the annexation of Crimea to be illegal, and since March 2014, the European Union has adopted and gradually extended[2] sanctions against the Russian Federation, due to its role in the deliberate destabilisation of Ukraine and escalation of the conflict. These involve diplomatic measures such as cancelling EU-Russia summits; asset freezes and visa bans applied to companies and individuals; banning investment in and prohibiting imports from and exports to Crimea and Sevastopol; and specific financial and economic sanctions targeting sectoral and economic cooperation with the Russian Federation (see Annex).

The period of sanctions was extended due to a lack of de-escalatory measures by the Russian Federation and the Council's[3] recent decision on the matter stipulates that they will remain in force until 31 January 2016 (Crimea and Sevastopol-specific sanctions are extended until 23 June 2016).

Exemptions from sanctions

Most notably, **gas** was exempted from sanctions because numerous EU Member States depend heavily on Russian supplies. With regard to financial sanctions, **EU subsidiaries** of blacklisted Russian banks operating in at least seven Member States (including France, Germany, Austria and Cyprus) are exempt.[4] These subsidiaries held over €20 billion of assets at the end of 2013. Finally, an exemption exists for activities under pre-existing contracts, which is considered by many experts to have created substantial loopholes.

Russian countermeasures

On 6 August 2014, Russian President, Vladimir Putin signed an edict prohibiting (or limiting), for a period of one year, the import of agricultural products, raw materials and food originating in countries that have imposed sanctions against Russian entities or individuals. On 7 August 2014, the Russian government adopted a list of products to be banned, which includes various products from several groups: fruit and vegetables, dairy and meat. The list was further revised on 20 August 2014.

The targeted countries are the Member States of the European Union, the United States, Australia, Canada and Norway. Since 73% of the banned imports come from the EU, it will be the most affected among all those targeted by Russian countersanctions. In the summer of 2015, Russia decreed the extension of these countermeasures for a further year, starting from 24 June 2015. On 13 August 2015, the Russian government made a further statement announcing that the food embargo would be expanded to cover listed food products originating in Albania, Montenegro, Iceland, and Liechtenstein.

The sanctions coalition

Other countries which imposed sanctions on Russia in reaction to the Ukraine crisis include the United States, Norway, Switzerland, Canada, Japan and Australia. Their scope is similar to EU measures and focuses on visa sanctions, asset freezes, financial restrictions applied to banks and enterprises, restrictions on export of dual-use technologies and sectoral bans on the sale of technology for deep-sea oil production. Some analysts underline that the design of the EU, US and other countries' sanctions system is multi-dimensional – an affected entity may, for example, be covered by one restriction (e.g. asset freezes) but the measures may also be bundled together. Furthermore, President Barack Obama reportedly asserted that combined sanctions would have a bigger impact on Russia. This is in line with the view shared by many economists, who agree that multilateral sanctions are more effective than unilateral ones.

Exemptions from countersanctions

Exemptions to the embargo include baby food, selected animal products (fat, meat offal) and live animals, as well as some prepared products in the fruit and vegetables sector (e.g. fruit juices or canned fruit). Furthermore, lactose-free milk and milk products, salmon fry, seed potatoes, onion sets, hybrid sweetcorn and dietary supplements are also exempt.

Effects of Russian sanctions on the EU economy

Complex interdependencies

In 2014, EU goods exports to Russia fell, with estimates of the decrease varying from 12.1% to as much as 14.5%. However, it is difficult to disentangle the effects of the mutual sanctions from weakened Russian demand on markets without sanctions. Linking diminishing trade volumes/economic losses directly to sanctions imposed is not straightforward,[5] as they coincide with two other major negative shocks affecting the Russian economy: a steep drop in oil and raw material prices and a sharp decline in the rouble's value.[6] The impact on the EU economy is also quite complex. In addition to the

sanctions and countersanctions, there are also indirect effects of the trade disruption caused by the high level of economic integration of EU countries (e.g. falling internal prices due to increased competition on the internal market, to which the embargoed goods were diverted). On the other hand, the loss of exports to Russia may have been compensated for, to a certain extent, by finding alternative markets elsewhere.

Exports to Russia have been affected in two ways. Firstly, by the EU ban on the sales of certain goods, such as 'dual-use' technology intended for the exploration of oil and gas deposits, and by the Russian import embargoes imposed in retaliation for EU sanctions, for example on meat. EU suppliers of these products will inevitably incur some losses. Secondly, the rouble's depreciation, exacerbated by capital flight from Russia, has weakened Russian purchasing power.[7] Since sanctions and the economic crisis in Russia are intertwined, areas of exports not subject to sanctions also face deteriorating prospects, due to spill-over effects and the worsening economic situation.

In a broader context, some consider that sanctions are 'closely connected and interact' with the fall in oil prices (even though this process started before the sanctions), which creates many benefits for the EU economy (e.g. increased purchasing power, lower production costs).

***Mistral* assault ships**

The biggest loss (and most prominent case) due to the ban on military exports is France's €1.2 billion contract to supply Russia with two *Mistral* amphibious helicopter carriers. According to French officials, cancelling the contract cost 'at least €1 billion', as the government has to repay the money it already received from Russia, plus a penalty for breach of contract (possibly as high as €250 million). Recently, the media reported that France has agreed the sale of the ships to Egypt instead for €950 million, which will help offset the cost of cancelling the transaction with the Russian Federation.

Some estimates

The European Commission has reportedly assessed that the damage to Europe's economy will 'remain contained'. A document leaked to the media reports that the Commission estimated the overall effect of sanctions and countersanctions as **-0.3%** of the EU's GDP in 2014 and **-0.4%** in 2015 (€40 and €50 billion respectively).[8] In its Spring 2015 Economic Forecast, the Commission stated that 'geopolitical tensions relating to Ukraine and the ensuing imposition of sanctions on Russia have had an impact on confidence and also some direct impact on trade, investment and on financial markets. These tensions are estimated to **lower growth** by around a quarter of a percentage point in 2015.'

An EU Institute for Security Studies macro evaluation showed a **modest impact** on EU trade: the stagnation in the Russian economy predicted before the Ukraine crisis unfolded would have caused a contraction in bilateral trade anyway.

The EU bans on exports of arms, dual-use equipment and innovative technology, while strategically important, has **little immediate impact** on trade volumes. However, there is a more pronounced effect on the agri-food sector (see agri-food section).

The Austrian Institute of Economic Research (WIFO) analysis for the EU and Switzerland considers that the export ban on products directly covered by these and Russian countersanctions will cause limited overall economic damage to economies within the EU. The researchers concluded that: 'The macroeconomic effects of the trade loss, amounting to **€34 billion in value added** in the short run and **€92 billion in the longer run**, are much more a result of a general worsening of trade relations between the EU

and Russia.'[9] Nevertheless, the observed decrease in exports and tourism expenditure of approximately €44 billion due to sanctions was estimated to result in a loss of **0.9 million jobs** in the short term. A longer-term view suggests that up to **2.2 million jobs** (around 1% of total employment) could be lost.

A research paper from the Vienna Institute for International Economic Studies estimates EU losses due to sanctions and conflict in Ukraine to be around **€11 billion** in the modest scenario of a 10% decline in exports to Russia. However, in a less likely but more extreme scenario of escalating sanctions,[10] which would have halved EU exports, the estimated losses are **€55 billion**.

Moody's predicts increases in gas prices and reduced confidence levels as the main channels through which the deterioration in EU-Russian relationships could affect EU growth. However, even in more extreme scenarios of significant trade disruptions and soaring gas prices, Moody's believes that the overall impact on EU GDP growth would be limited to less than **one percentage point in 2015**.

A view from Russia

The Institute of Economic Forecasting of the Russian Academy of Sciences paper on the effect of sanctions in both Russia and the EU estimates that European financial institutions suffer annual losses of US$8-10 billion from a reduction in interest payments. Reduced economic cooperation and a ban on supplies of dual-use technologies are likely to cost the EU about US$10-15 billion. In the long term, and if sanctions escalate, oil production in Russia may fall by 10-15% by 2030, which would then lead to a hike in energy costs of US$3 billion annually in the EU.

The authors also argue that sanctions will lead to the development of EU import substitution both through internal production and by finding other suppliers. Furthermore, adding a demand restraint that will not be compensated and a multiplier effect (the 'second-round' effect on the suppliers of companies exporting to Russia) resulting from the interruption of trade, the total effects stemming from the indirect impact would be magnified. The authors also claim that, apart from the drop in demand from Russia, intersectoral ties in the European economy are likely to exacerbate effects in other industries and sectors. They expect a reduction in agricultural production and food industries by 0.9%; in the chemical, textile, clothing and leather industries by 0.7%; in machinery and equipment by 1%; in electrical equipment by 0.65%; and in transport vehicles by 1.3%; as a consequence of sanctions and countersanctions. They assume a total decrease in EU production input to be as much as **US$180 billion**.

The Russian researchers conclude that 'most effects from continuation of sanctions policy involve both direct and indirect consequences and affect the structural characteristics of economic development. Unlike direct effects, total effects from sanctions are macroeconomically significant both for Russia and the EU. The potential adverse impact of sanctions on the Russian economy is estimated at 8-10% of GDP and that on the EU economy at some **0.5% of GDP**'.

Geographical and sectoral distribution

Existing research concludes that the effects of sanctions and countersanctions are not distributed evenly across the EU. WIFO found geographical closeness to be highly correlated with the size of the effects at the national level: Baltic countries, Finland and eastern European countries will be affected more than the EU average of 0.3% of GDP in the short term and 0.8% in the long run. These countries are amongst those with the highest exposure to trade with Russia as a percentage of their GDP. In absolute values Germany, as the biggest exporter to Russia, is unsurprisingly likely to be the most affected.

The WIFO paper estimates that, in the short-term scenario, the exporting industries and their suppliers, as well as industries specialised in the production of investment goods will be the most affected. These effects are then likely to spread to industries that are more dependent on final household demand which, they argue, will gradually decrease. Hence, agriculture and manufacturers of food products, the metal product industry, the manufacturing of machinery, equipment and motor vehicles, as well as manufacturing related services (wholesale, business services), would be the industries most affected in the short term. In a longer perspective, construction, wholesale trade, business services and retail trade will also increasingly be affected.

Reports from individual Member States show that the effects on trade of sanctions and the deteriorating economic situation in Russia also vary considerably within the same sectors: e.g. in 2014 France noted a fall of 12% in transport equipment exports while Italy has seen its transport equipment exports plummet by 42%.

Financial sector

Russia has received loans from European financial institutions, and some could face significant risks if Russian companies or banks were to default. Some estimate that approximately US$147 billion of Russian debt is held by European lenders, whilst others claim EU bank exposure is as much as US$165 billion. France is by far the most exposed country, with approximately US$44 billion in outstanding loans to Russia, followed by Italy (US$27 billion), Germany (US$17 billion), and the UK (US$15 billion).

In its January 2015 report, the European Banking Authority (EBA) warned that 'Non-Performing Loans may rise significantly as these emerging economies slow down – some of them, such as Ukraine and Russia, due to political uncertainty. In addition, increasing uncertainties and risk aversion may translate into a repricing in financial markets and higher levels of banks' funding costs. The possibility of sanctions against banks and other counterparties (...) may also create some volatility and tensions; consequently, banks and supervisors will need to continue monitoring external exposures to emerging markets and discuss contingency plans.' In its June 2015 report, however, the EBA does not signal risks stemming from exposure to Russia.

Large-scale defaults by Russian debtors, if they were to happen, could worsen the financial position of some EU banks but, according to the majority of experts, not to the point of risking the stability of the whole European banking system. Although French banks have a large presence in Russia via banking subsidiaries; they are also considered to be safe from the risk of default. Deutsche Bank sees elevated risks for EU banks only in the unlikely event of Russia defaulting on its securities.

Impact on the EU agri-food sector

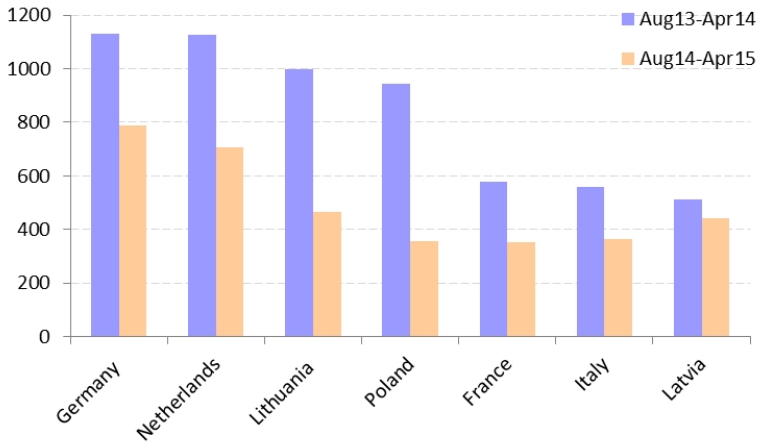
EU agri-food exports account for 7% of total EU exports of goods. About 9% of these agri-food exports go to Russia, which is the second most important destination for EU agricultural products, after the USA. In 2013, overall EU agricultural exports to Russia were worth €11.3 billion. The Russian countersanctions covered about 43% of these exports, worth approximately €5.1 billion (representing about 4.2% of total EU agri-food exports). However, the embargo does not include many important sub-sectors, such as wine and spirits, cereals, pasta, olive oil, beverages, and a range of other products.

Looking at the trade volumes, between August 2014 and July 2015, EU agri-food exports to Russia fell **by 43%, from €11 billion to €6.3 billion**.[11] This can be explained not only

by the almost complete disappearance of exports of banned products, but also by a decrease in exports not covered by the embargo.[12]

The European Parliament's Policy Department for Economy and Scientific Policy concludes that the limited data available for 2014 did not suggest a large number of job losses in the sector, but that damage in certain regions and sectors is nevertheless likely to be considerable. The World Bank has also evaluated the impact as small overall, but substantial for some sectors.[13] An early 2014 forecast indicated that the losses of US$6.7 billion due to the embargo could endanger as many as 130 000 jobs in the agricultural sector.

Figure 2 – Agri-food exports values to Russia, selected Member States (in € million)



Data source: European Commission, DG Agriculture, 2015.

Looking at the overall effect, however, in August 2015 the Commission assessed that: 'in most regions, most of the affected sectors have been able to find alternative markets either within the EU or beyond'. It consequently estimated that the EU agri-food sector was able to compensate for losses on Russian markets because, since the embargo was put in place, the value of overall EU exports to third countries has increased by 5.7%.

Some argue that the alternative markets may not be as remunerative as the Russian market, leading to some losses for food producers nonetheless. The European Bank for Reconstruction and Development has warned that the ban may result in an oversupply of affected goods in the EU, thus possibly creating downward pressure on their prices (which has indeed been reported in some large agri-food producing Member States, e.g. France and Italy). Farmers' associations have also warned of a boom in domestic Russian production of imitations of embargoed foods and the possible long-term damage to the image of European products.

The European Parliament

The European Parliament (EP) has consistently[14] supported further rounds of sanctions imposed on the Russian Federation in the context of its involvement in Ukraine and the gradual escalation of the conflict. Notably, the EP has underlined that the measures could have been introduced earlier; called for sanctions against Russian energy firms; stressed the need to lower the EU's dependency on Russian gas; and called on the Commission to monitor the impact of the Russian countermeasures and to take action to support producers affected by these trade restrictions. MEPs have also stressed that the sole aim of EU sanctions is to persuade the Russian government to commit to a change in its current policy and contribute to a peaceful resolution of the Ukrainian crisis, and that the sanctions regime should be strengthened should Russia choose to continue, directly or indirectly, to destabilise Ukraine and to compromise its territorial integrity.

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Endnote

[1] Many analysts point to deeper-rooted reasons for the slowing of the Russian economy in 2013, such as a difficult business environment and an over-reliance on commodities.

[2] For details see e.g. the Fact Sheet of the European External Action Service on EU-Ukraine relations.

[3] The European Union applies restrictive measures (or sanctions) within the framework of the Common Foreign and Security Policy (CFSP). These may be diplomatic or economic in nature and are intended to bring about a change in policies which either violate international law or human rights or are disrespectful of the rule of law or democratic principles. These sanctions are imposed through a CFSP Council Decision adopted by unanimity.

[4] Some commentators see this as an important loophole in the sanctions regime and argue that the ECB preferred to exempt the subsidiaries in order to avoid risking the stability of the European banking system.

[5] For a more detailed discussion on how the sanctions and countersanctions interact with the Russian economy and the difficulties with attributing changes in trade flows purely to sanctions see for example World Banks' Economic Report on Russia of April 2015.

[6] For example, the rouble lost a third of its value over a period of three weeks in December 2014.

[7] While manufacturing industries in the EU experience the indirect effect of sanctions via lower demand from Russia for exports, the overall decrease in exports is more likely to occur due to the deteriorating state of the Russian economy, not sanctions per se. For example, Turkey also experienced a drop in exports to Russia by 13% in 2014, despite not being exposed to countersanctions and amidst high initial expectations that the supply of goods to Russia would be to some extent diverted from the EU to Turkey.

[8] Other sources report that the Commissions' analysis mentioned a 0.2 to 0.3 percentage point effect on GDP.

[9] For example: Russia, despite its accession to the WTO in 2012, maintains trade barriers such as excessive safety requirements, subsidising domestic manufacturers or outright embargos on some products, on grounds contested in the WTO forum.

[10] Such as interruption of Russian gas supplies to EU, confiscation of Western assets and wholesale travel bans.

[11] However, Russia banned EU pork meat and Polish exports of fruits and vegetables before any countersanctions were put in place.

[12] For example, despite no sanctions, Italian wine exports fell by 39% and vermouth and spirits by as much as 50%. This can partially be explained by weakening Russian demand due to the crisis and low value of the rouble.

[13] For details on effects on particular sectors and countries see, e.g. European Commission, Report on Agri-food trade in 2014.

[14] For example, Resolutions of 12 December 2013, 6 February 2014, 27 February 2014, 13 March 2014, 17 April 2014, 17 July 2014, 18 September 2014, 15 January 2015 and 10 June 2015.

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Annex – Overview of EU sanctions against the Russian Federation

Diplomatic measures
In 2014, a G7 summit was held in Brussels instead of a G8 summit in Sochi. The EU has also suspended Russia's negotiations on joining the OECD and the International Energy Agency.
The EU-Russia summit was cancelled and EU Member States decided not to hold regular bilateral summits. The negotiations with Russia on visa matters, as well as on the New Agreement between the EU and Russia, were suspended.
Restrictive measures
Asset freezes and visa bans have been applied to 151 persons, while 37 entities have been subjected to a freeze of their assets in the EU.
Restrictions for Crimea and Sevastopol
Imports originating from the Crimea and Sevastopol are prohibited in the EU unless accompanied by a certificate of origin from the Ukrainian authorities.
Investment in the Crimea or Sevastopol is forbidden. Europeans and EU-based companies may not purchase real estate or entities there, finance Crimean companies or supply related services.
EU operators are no longer allowed to offer tourism services in the Crimea or Sevastopol. European cruise ships may only call at ports in the Crimean peninsula in case of emergency. This applies to all ships owned or controlled by a European or flying the flag of an EU Member State.
The export of certain goods and technology to Crimean companies or for use in the Crimea has been outlawed. These include the transport, telecommunications and energy sectors as well as the prospection, exploration and production of oil, gas and mineral resources. Furthermore, technical assistance, brokering, construction or engineering services related to infrastructure in the same sectors must not be provided.
Economic sanctions (targeting sectoral cooperation and exchanges with Russia)
It is forbidden for EU nationals and companies to buy or sell new bonds, equity or similar financial instruments with a maturity exceeding 30 days, issued by five major state-owned Russian banks and their subsidiaries outside the EU, three major Russian energy companies and three Russian defence companies. Services related to the issuing of such financial instruments are also banned.
EU nationals and companies may not provide loans to five major Russian state-owned banks.
There is an embargo on the import and export of arms and related material from/to Russia, applying to all items on the EU common military list (unless for use by the EU space industry).
Exports of dual-use goods and technology for military use in Russia or to Russian military end-users, including all items in the EU list of dual-use goods, are prohibited. Export of dual-use goods to nine mixed defence companies is also forbidden.
Exports of certain energy-related equipment and technology to Russia are now subject to prior authorisation by the Member States. Licences for products destined for deep water and Arctic oil exploration and production, as well as shale oil projects will be denied.
Services necessary for deep water oil exploration and production, Arctic oil exploration or production and shale oil projects in Russia may not be provided.
Measures concerning economic cooperation
The European Council requested the European Investment Bank suspend the signing of new financing operations in Russia. The Member States will also coordinate their positions within the Board of Directors of the European Bank for Reconstruction and Development, aiming also to suspend financing of new operations in the Russian Federation.
The Council invited the Commission to re-assess EU-Russia bilateral and regional cooperation programmes with a view to taking (on a case-by-case basis) a decision on the suspension of their implementation. Projects dedicated exclusively to cross-border cooperation and civil society will be maintained.

Source: European Commission.