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Statement before the Senate Committee on Banking, Housing and Urban Affairs
On "Countering Russia: Assessing New Tools"

Raising the Domestic Political Costs of Vladimir Putin's Policies

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Thank you Chairman Crapo, Ranking Member Brown, and Members of the Committee:

Before we discuss and evaluate specific measures, I think it might be helpful to begin by placing the sanctions on Vladimir Putin's regime (which is not to be equated with Russia or the Russian people!) in a larger context.

Why are sanctions, like those on Russia, imposed on countries? Essentially to exact domestic political costs on a country's foreign policy.

If that is the main purpose, there are two distinctions that need to be made in evaluating the impact of sanctions. One is short-term vs. medium- and long-term effects. And the other, more important distinction, is the difference between economic effects and political effectiveness. The former are relatively easy to achieve, especially when the disparity between the respective economies is as great as it is between the United States and Russia today. But the latter purpose, to change the policies of the sanctioned regime, is almost never achieved in the short term and has not been especially successful in the medium term either.

This has been the case almost everywhere and at all times. One reason is the hope that the sanctions will be lifted or at least lightened. Secondly, and most importantly, authoritarian regimes, even the seemingly stable ones, carry on what Churchill called the fight of bulldogs under the carpet. A quick retreat could lead to a hemorrhaging and eventually loss of the leader's power, which could be accompanied by the loss of one's life as well. Hence, defiance is almost always the first reaction.

Thus far, Russia has fit the general pattern, both with respect to the economic effects of the sanctions and their political effectiveness. Which is to say that the economic effects have been undeniable, damaging, and growing – but equally predictable has been the regime's defiance in the face of these sanctions. Alexei Kudrin, Putin's former and longest-serving Minister of Finance and still reportedly among Putin's most trusted economic advisors, has estimated the losses from sanctions and the absorption of Crimea into the Russian Federation from 2014 to 2017 at $100-150 billion in a country whose GDP last year was around $1.57 trillion.[1]

[1] "Russia's losses from Crimea integration estimated at $150-200 bln — ex-finance minister," TASS, March 31 2015, http://tass.ru/en/russia/786132

Similarly, according to the International Monetary Fund, the sanctions could initially reduce Russia's inflation-adjusted GDP to between 1 and 1.5 percent.[2] The actual losses are almost certainly higher because of the impact of capital flight, the drop in foreign direct investment, and imports of technology in a country where 90 percent of industry operates on imported equipment (and 100 percent in the most advanced sectors).

As to the pattern of defiance in the face of the sanctions, there is no need to detail it to this audience; a short list of Russia's *post*-sanctions actions would do: the shooting down of a Malaysian airliner over Russia-controlled territory in July 2014; six months later the deployment of regular Russian troops in the battle against Ukrainian forces around the town of Debaltseve; nine months later the sending of Russian troops to Syria; a year later an attempted coup in Montenegro to prevent it from joining NATO; and then of course the interference into the US presidential election and the poisoning of a former intelligence officer in Britain.

But the seeming absence of immediate political effects of the sanctions must not be confused with their ineffectiveness.

To begin with, we should not underestimate the power of moral outrage which the sanctions represent – especially if they are initiated by the only country that ultimately matters to Russians: America. As we learned after the Soviet Union collapsed, the moral outrage which US sanctions represented chipped away at the regime's legitimacy. And Russia is not a totalitarian country. Public opinion matters.

Similarly, we should keep in mind, and not be disheartened by the fact there are no silver bullets and it is very hard to invent something that is both new and effective. As a result, the several packages of measures in the pipeline today, including the DETER legislation, appear most effective when they build on or deepen the existing sanctions that are most likely to have a domestic political impact.
I would single out two such measures.

First, the earlier ban on investment in and transfer of technology to the Russian oil industry – a measure that is furthered by the DETER package to including "blocking" or freezing assets of two of Russia's three largest oil companies.
This is a ticking bomb under the Putin regime.

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[2] Anders Aslund, "Want to hit Putin where it hurts? Target his friends," The Hill, September 2 2018 http://thehill.com/opinion/international/404524-want-to-hit-putin-where-it-hurts-target-his-friends

A former head of the Russia office of an oil multinational has commented in an elite Russian on-line journal that, I quote my translation, “From my own experience… I know that without western technologies and investors the oil-and-gas sector of Russia would be on a deathbed.”[3]

True, Russia is not a petro-state like Saudi Arabia. No more than 15-20 percent of its GDP comes from oil and gas. But the tax revenues from energy exports constitute at least 50 percent of the Russian state budget. This is ready cash for President Putin to pay for his key political assets: the security services, the armed forces, over 36 million pensioners[4], and millions of public-sector workers. Yes, in theory, if he does not have the money to feed these constituencies Putin may decide to turn Russia into a totalitarian state like Cuba or North Korea, where public opinion does not matter at all. Does he have the temperament for the inevitable bloodshed or for the risks involved? He may or may not. We simply don’t know. But these are exactly the kind of tough choices that sanctions should be designed to force Putin to make.

The ban on financing and technology transfer is a ticking bomb because while Russia is not running out of oil, it is beginning to run out cheap oil in Western Siberia. There is plenty of oil still left in Russia, more than any other country in the world, but most of it in Northeast Siberia is at or above the Arctic Circle, under permafrost, much of it offshore in the Kara Sea, Laptev Sea, and the East Siberia Sea. Virtually all of it must be mined at temperatures between minus 22 and minus 55 degrees Fahrenheit.

The startup investment in exploration and extraction is likely to run into the hundreds of billions of dollars, which Russia does not have – in addition to the required technology that Russia cannot even touch.

The second measure that is likely to have a sizeable domestic political effect is the restrictions under the DETER legislation that ban the sale of Russian sovereign debt. This policy builds on the already existing restrictions on raising capital by several Russian private companies and banks.

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[3] Konstantin Eggert, “Voina budet proigrana. Pochemu putinskaya elita boitsya sanktsii bol’she sovetskoi” (The war will be lost. Why the Putin elite fears sanctions more than the Soviet elite,” Snob, August 10 2018 https://snob.ru/entry/164380.

[4] “Kakoe kolichestvo pensionerov zafiksirovano v Rossii v 2017 godu” (How many pensioners are registered in Russia in 2017”), Straxovoi Portal https://insur-portal.ru/pension/kolichestvo-pensionerov-v-rossii

This past August, Russian media labelled the 14-day limit on operations with sovereign debt the “most serious threats to the Russian economy.”[5]
An outright ban on the sale of the OFZ, the Russian acronym for Obligatsii Federal’nogo Zayoma, or Federal Loan Bonds would be a very serious blow. As a Russia expert put it, OFZ’s are the “Finance Ministry’s workhorse funding instrument for the budget.”[6]

A third of Russian state debt is already held by foreigners, and Russian experts anticipate a massive fire sell-off for cents on the dollar and “non-residents exit” from Russian “papers.”[7] Finally, the sale of sovereign debt, according to Russian experts, helps finance, among others, the Russian Pension Fund.[8]

Moreover, an ambitious economic program announced by President Putin after his inauguration this past May calls for nearly $115 billion in additional spending over the next six years, and – along with hiking the Value Added Tax from 18 to 20 percent,[9] and raising the retirement age, the Finance Ministry had planned to raise nearly $36 billion by selling the OFZs, most of them to foreign investors.[10]

In conclusion, making Vladimir Putin moderate, not to mention retreat from, his current aggressive policies will require measures targeted as precisely as possible at increasing the domestic political costs of his regime’s behavior – as well as a great deal of patience.

Thank you, Mr. Chairman.

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[5] Arnold Khachaturov, “Rubl’ trepeshchet” (The ruble is trembling”, *Novaya Gazeta*, August 9, 2018 https://www.novayagazeta.ru/articles/2018/08/09/77446-rubl-trepeschet.

[6] Ben Aris, “Even the Specter of Sanctions is Hurting Russia,” *The Moscow Times*, August 25, 2018, https://themoscowtimes.com/articles/even-the-specter-of-sanctions-is-hurting-russia-op-ed-62666.

[7] Khachaturov, op.cit.

[8] See, for example, Vladislav Inozemtsev, “Prishli za Putinym” (They’ve come for Putin), Forbes.ru, August 9, 2018, http://www.forbes.ru/biznes/365639-prishli-za-putinym-chem-grozyat-kremlyu-novye-sankcii-ssha.

[9] “Russia’s Duma Passes Bill Raising Value-Added Tax to 20%,” The Moscow Times, July 24 2018, https://themoscowtimes.com/news/russia-duma-passes-bill-raising-value-added-tax-20-percent-62331

[10] Ben Aris, “Russian government gets a new programme and people,” bne Intellinews, May 20 2018 http://www.forbes.ru/biznes/365639-prishli-za-putinym-chem-grozyat-kremlyu-novye-sankcii-ssha ; and see Aris, “Specter of Sanctions”