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Introduction

Chairman Crapo, Ranking Member Brown and distinguished Members of the Committee, thank you for the opportunity to testify at today's hearing assessing U.S. Sanctions on Russia. My name is Rodney Ludema, and I am a professor of economics at Georgetown University. Earlier this year, my co-author Daniel Ahn and I published a report titled, "Measuring Smartness: Understanding the Economic Impact of Targeted Sanctions,"[1] and I would like to take the opportunity to share some of its conclusions.

As you know, Russia's intervention in Ukraine in early 2014 prompted the United States and the European Union to impose series of "smart" sanctions – sanctions against specific individuals and companies, primarily in Russia and Ukraine. The sanctions began in March 2014, and the list of targets has grown steadily, now affecting several hundred companies explicitly and thousands more by association. Our study seeks to understand just how "smart" these sanctions have been in practice. That is, have they hit the intended targets with minimal collateral damage? We find that, with a few notable exceptions, the sanctions have inflicted significant damage on the intended targets, with relatively little short-run impact on the overall Russian economy.

Smart Sanctions in Context

While broad economic sanctions and trade embargoes have long been used as instruments of foreign policy, targeted sanctions focusing on specific individuals, companies, and transactions are relatively new. They are an outgrowth of a recognition that the effectiveness of an economic sanction in gaining compliance from a target government does not depend on the

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[1] The public link to the report can be at https://www.state.gov/documents/organization/267590

overall economic damage the sanction causes but on whether the target government itself and its key domestic constituencies feel the economic pain from noncompliance. Thus, sanctions are considered "smart" if they target responsible parties while minimizing collateral damage. For this reason, assessing the smartness of targeted sanctions on Russia is essential to assessing their efficacy.

Clouding the picture, however, is the fact that the conflict in 2014 roughly coincided with a series of powerful macroeconomic shocks, especially a dramatic decline in the price of oil (Russia's main export), which jolted both the Russian and world economies. The Russian economy slowed dramatically in 2014 and entered recession in 2015. This makes it difficult to determine with the naked eye whether the poor economic performance of a sanctioned company is due to sanctions or to the broader economic problems of the country. Likewise, it is difficult to determine whether the broader economic problems of the country are due to the oil shock or to collateral damage from sanctions.

The difficulty inherent in attributing Russia's poor economic performance following sanctions to a single cause has allowed for a wide range of conflicting claims regarding the economic costs of the sanctions to Russia and to neighboring economies. Opponents of sanctions, in particular, claim that sanctions have caused little pain to the specific targets, while inflicting untold economic damage on the Russian people and on neighboring countries (principally members of the EU).

Effects on Sanctioned and Associated Companies

The first part our study examines whether the sanctions impacted the intended targets. We assemble all companies listed on the Specially Designated Nationals and Blocked Persons (SDN) List and Sectoral Sanctions Identifications (SSI) List, along with all companies associated

with individuals on the SDN list. Together with overlapping targets from a similar set of sanctions by the European Union, this comprises 584 unique targets. (In continuing research, we have also considered some 2,000 subsidiaries of these targeted companies and found similar results.)

Our method is to compare the performance of sanctioned companies to that of non-sanctioned peer companies before and after the sanctions were imposed. As sanctioned and non-sanctioned companies all face the same macroeconomic environment, comparing the two groups is a way to isolate the effect of sanctions. Our main finding is that sanctioned companies are indeed harmed by sanctions relative to their non-sanctioned peers. On average, a sanctioned company loses an estimated:

- one-third of its operating revenue
- over one-half of its asset value
- about one-third of its employees

after being targeted compared to non-sanctioned companies. These estimates, which are large and appear highly statistically robust, suggest targeted sanctions do have a powerful impact on the targets themselves.

Beyond the broader strategic implications, these sanctions may therefore be tactically impairing the ability of the Russian Federation through these companies to further the illegal annexation of Crimea and the ongoing crisis in Eastern Ukraine.

Macroeconomic Impacts

The second part of our study examines collateral damage. In particular, we consider impact the sanctions on Russian GDP and on its imports from the EU. In contrast to the firm-level approach, it is not possible to cleanly separate out the effect of sanctions from the effect of

other macroeconomic factors in the aggregate analysis. Instead, we pose a much simpler question: how much of the post-sanction performance of the Russian economy can be explained either directly or indirectly by falling oil prices?

The world oil price (Brent) fell from over $100 in 2013 to under $60 by the end of 2014, and declined further in the second half of 2015. A common rule of thumb for oil exporters suggests a $40 drop in the world price of oil should shrink energy-dependent Russia's GDP by four to five percent. Indeed, we find that the oil price change explains the vast majority of the decline in Russia's GDP and import demand, with very little left to be explained by sanctions or other factors. We conclude that either sanctions had only a small negative effect on Russia's GDP or other positive factors largely cancelled out the effect of sanctions.

There is good reason to believe that sanctions have had only a small negative macroeconomic effect in the first two years of their imposition. By far the largest companies on the sanctions list (energy companies, banks and defense companies, which make up a large fraction of the Russian economy) were not subject to blocking sanctions. Rather, they were subject to limitations on long-term borrowing and new technologies that, *by design*, should have a delayed effect. The reason for this design was to mitigate the potential negative impacts on U.S. companies and those of our allies.

As for positive factors that may have countered the effect of sanctions, the most plausible candidate factor would be the Russian policy response. Notable policy responses were the large depreciation of the Ruble in 2014, and government bailouts certain "strategic" firms. The government of Russia designates certain firms as strategic because of their economic and national security importance to be prioritized to receive state largess in the form of state loans guarantees, capital participation, more government contracts, and tax breaks. It is important to

note that such policy responses are costly to the Russian government, and thus this constitutes an indirect avenue by which the sanction effect is felt.

Finally, we find that sanctions have had a small effect on the economies of most EU countries. Adding together the impacts of sanctions and Russia's agricultural countersanctions on EU exports gives a median impact across EU countries of just -0.13 percent of GDP (though with considerable variation across the EU members). The reasons for this are: (1) Russia generally accounts for a small share of total EU countries' exports; and (2) most of the decline in Russian imports is explained by lower oil prices and trend factors.

Conclusions and Implications for Future Sanctions

Economic sanctions are meant to signal international disapproval, deter further aggression, and create leverage in negotiations with the targeted country aimed at reversing the offending policies. Whether the current set of sanctions against Russia will ultimately accomplish these goals is unknown, but good sanctions design gives the United States and its allies the best chance of success.

History teaches that sanctions are most effective when they are multilateral, sustainable, focused, and clearly contingent on an achievable goal. The current sanctions on Russia were designed with these principles in mind. While not fully multilateral, they include the EU, which is a region of great importance to the Russian economy. They were designed to cause minimal collateral damage in the short term and thus have proven sustainable so far. Our study largely confirms the success of this design element. Any new sanctions, if targeted at the broader Russian economy, could easily cause collateral damage and thus should be approached with caution. The current sanctions were designed to focus their impact on the companies and individuals involved furthering Russia's illegal annexation of Crimea and ongoing Ukraine

policy. Our study largely confirms the success of this design aspect as well. Any new sanctions targeting different policies should be similarly targeted.

Finally, current sanctions are contingent on certain Minsk II milestones, and while they have yet to be reached, they are clear. Sanctions policies that tie the hands of negotiators in such a way as to prevent achieving the goal should be avoided.