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## ECONOMIC SANCTIONS AND IMPORT SUBSTITUTION\*

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**Abstract.** The article focuses on the economic sanctions theory development in the modern global economy. The content of the economic sanctions theory and practice transformation under the influence of internationalization and globalization of markets for goods and services is disclosed. The study analyzes the economic content of sanctions. The goals and grounds for imposing sanctions are defined. The authors classify the types and forms of economic sanctions applied in the modern global economy. The conditions for achieving an impact of economic sanctions are formulated. The attempt is made to assess the economic efficiency of sanctions and their counter-sanction measures. The losses and consequences, both for the countries imposing the sanctions and for countries under pressure, are identified. Factors affecting the distribution of losses from the imposition of economic sanctions are disclosed. The main directions of the economic sanctions content and application practice transformation in the global economy are identified.

**Keywords:** Economic and political sanctions; embargo; import substitution; motives; goals; loss; consequences; sanctions pressure; countries subject to sanctions; countries imposing sanctions

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### 1. Introduction

Thus far, economic literature still does not have a precise and comprehensive definition of economic sanctions, and the mechanism for their imposing, the reasons and grounds that influence the decision-making process on imposing sanctions, are not explicitly defined and transparent. Economic sanctions have become a frequent international practice, while the political and legal aspects of the imposing have not been determined yet. This

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state of things clearly indicates that this process needs theoretical understanding in the globalizing world, especially today, when there is a transformation of the very process of imposing sanctions: it acquires specific features and new consequences both for the countries subject to sanctions and for those imposing them. And it is very important to find an answer to the question that was bluntly raised during the discussion on sanctions: are they new opportunities for cooperation, or highly negative set of factors and threats that destroy the economy subject to sanctions?

## **2. Theoretical and Methodological Grounds of the Research**

To analyze the economic content of sanctions, reasons, and grounds for their imposing, as well as the types of economic sanctions and their economic efficiency, it is necessary to use the main approaches of system analysis, including structural and reproduction, as well as genetic and institutional approaches. The "economy of sanctions" as a field of research is an integral part of the institutional theory. It is represented in the works of Western academic economists to the fullest extent possible since sanctions are an important element of the current foreign economic policy. Thus, various aspects of the economic sanctions study outcomes are presented in the works of such scientists as G.C. Hufbauer (Hufbauer et al. 2009), Th. Madies (Madies et al. 2013), S. Oxenstierna (Oxenstierna and Olsson 2015), Chen-yuan Tung (Tung 2002), J. Galtung (Galtung 1967); O. Finogentova (2018).

The interest in the economic sanctions study arose in Russia only in recent years after the imposition of certain external restrictions. At the same time, the growing interest of Russian academic scientists to this problem is concentrated today mainly on the applied aspects of sanctions and their counter-sanction effects (Klimova 2016). At the same time, the theoretical aspects of the economic performance study under conditions of sanctions are not enough. The content of economic sanctions, their types, methods and forms of application and other aspects of this problem require additional study.

## **3. Results**

The theory of sanctions has a long history, beginning with Ancient Rome. Western researchers gave particular prominence to the development of this theory related to institutional economics, while Russian scientists, including Soviet ones, did not pay enough attention to the analysis of the content, economic consequences of the application of these categories and the implementation of sanctions pressure processes. Over the last years, after imposing the sanctions by Western countries, Russian scientists addressed this issue, in the study of which a whole series of new questions arise.

Today the theory of sanctions under the conditions of the global economy is undergoing a very serious transformation due to the existing global markets for goods and services, the enhanced international division of labor, which leads to completely different consequences both for countries subject to sanctions and for those imposing them.

The global economy is so closely linked to the economic, political and social interests of countries that conceivably it becomes impossible to create operating conditions for the existence of an autarkic economy. Obviously, this negates the consequences of imposing sanctions. Another important new point is a fundamental change in the conditions for achieving the efficiency of economic sanctions, which cannot always lead to the desired consequences, that is, to the political and economic outcomes, to achieve which significant resources and funds have been spent.

What are economic sanctions, what is their content as an economic category?

At the broadest level, sanctions are certain restrictive measures against certain states, separate companies or individuals used as a response to any action. The obstacles for their activities created in this way can not only affect certain areas of development and the sphere of the economy but also be inclusive. Restrictions, obstacles, and difficulties to activities caused by sanctions are manifested at all levels of economic management. Their main goal is to create adverse conditions for the economy of the country, its subjects at the federal and regional levels, thereby calling them to change the chosen behavior strategy.

A conventional approach presumes that international legal sanctions are measures of compulsions that are applied centrally by the UN as a part of the collective security system. World practice includes the following influence restrictions as for the states:

- economic sanctions;
- political sanctions.

Economic measures mean a weakening of the economic situation and concern the restriction (perhaps even a complete prohibition) of foreign trade. For example, a state may impose a prohibition of goods export to the country that has been restricted. The prohibition also extends in the opposite direction: import of the same production stops. Since for most states, international relations are built on trade, suppliers lose market outlets, and consumers cannot purchase a number of goods, as their import is stopped. They have to look for new channels, which is connected with certain inconveniences and additional costs. In our opinion, the restrictions imposed on the import of goods are more severe and destructive. This is due to the fact that the countries-sellers under the conditions of the current heavy competition for product markets face the problem of selling the products. The goal of imposing political and economic sanctions is to achieve a situation where the state, the object of imposed restrictions, will be isolated to some extent from the rest of the world.

In most existing studies, economic sanctions are identified namely as an enforcement tool or a means of destabilization that applies to states, enterprises or a group of individuals (mainly members of national and regional elites), when they act contrary to the rules set by international rules. With this in mind, it should be emphasized that, in this connection, the content of the category "economic sanctions" is narrowed by focusing only on its political and legal component against its economic interpretation. At the same time, only in some publications, there is the opinion that sanctions can be both negative and positive by the nature of their impact (Baldwin 1971; Madies et al. 2013). Examples include humanitarian and investment assistance, the use of customs preferences.

Basically, sanctions are a severance of integration and cooperation ties, this is, as such, a blow to the theory and practice in the international division of labor, which ultimately reduces the costs of manufactured products, taking into account its production under the best possible conditions (Borisovskaya 2015; Zeibote et al. 2019). Sanctions challenge the import substitution, that is, the development of a closed autarkic reproduction system, regardless of real costs and rejecting the advantages of making maximum use of the international division of labor. Thus, they contradict the interests of the mutually beneficial contribution of countries in the system of international cooperative interaction and prevent the obtaining of benefits and advantages from the development of international trade. The importance of the political component of sanctions should also be noted since economic sanctions are often imposed in order to achieve certain political goals.

G.K. Hufbauer et al. used the following definition of economic sanctions: deliberate, government-inspired withdrawal, or threat of withdrawal, of customary trade or financial relations with political goals (Hufbauer et al. 2009).

The grounds for imposing sanctions are as follows:

- demonstration of resolve to achieve the desired political goal, which is the most frequent reason for sanctions;

– prevention of the future problem behavior of the subject of international relations limiting its political and economic independence;

–the interest of the country's authorities imposing the sanctions in demonstrating a strong foreign economic policy but at the same time their unwillingness to engage in open military conflicts.

The imposition of economic sanctions by a country or a group of countries has always been connected with the enforcement by the government of the countries that are subject to sanctions to change their policy. As a rule, sanctions are expressed by the prohibition of the import and/or export of goods and services, the restriction of financial transactions with corporations of these countries, the termination of economic partnership and investment.

An illustrative transformation example of the content and practice in the application of economic sanctions under the conditions of global peace is the situation concerning the Russian Federation. 2014 was a turning point for Russia, both politically and economically. The reason for the virtual isolation of the country in the world was the unstable situation in Ukraine and the annexation of the Crimea. The reaction was the imposition by 48 Western countries of several sets with economic sanctions. Although sanctions have been in effect for a long time, there have not been convincing impact ratings yet. Moreover, there is no common opinion about the full impact and losses of sanctions, not only in quantitative terms but even on a qualitative level.

What are the consequences of the imposition of economic and political sanctions against the Russian Federation? Experts state that the greatest difficulties arise in the sphere of import (Shevchenko 2017). The fact is that the Russian economy is quite dependent on the importation of high technology, engineering products, medicine and, considerably, food supplies. The main import partner is exactly the EU, which imposed sanctions. The result of the sanctions was a reduction in trade between Russia and the EU (table 1).

**Table 1.** The EU-Russia external trade turnover from January to July, USD million

	2014	2015	2016	2017	2018	2018 to 2014, %
EU countries	232278	143156	107965	137105	168233	72.4
from them:						
Belgium	7925	5248	4633	5704	7165	90.4
Germany	41219	27270	21441	27235	33651	81.6
Spain	5867	2968	2494	3061	3540	60.3
Italy	29975	19606	10831	13187	14998	50.0
Latvia	9228	5047	3166	3459	3004	32.6
Netherlands	45038	27217	18289	23098	26176	58.1
Poland	14689	8339	6579	8824	12037	81.9
Slovakia	5146	3279	2205	2905	3281	63.8
United Kingdom	12349	6989	5668	6688	8116	65.7
Finland	10102	5728	4647	6762	8711	86.2
France	11694	6558	6918	8363	10242	87.6
Czech Republic	6263	3588	2827	4045	4772	76.2

Source: Russian Federal State Statistics Service (n.d.).

Today the economic component of the relevant measures has a systemic nature, which led to a serious price advance on the domestic market, primarily on food products, as well as to the deficit of certain types of imported products. The impact of sanctions on the Russian economy was also manifested in the reduction of the volume of foreign investment capital attracted (Sinyakov et al. 2015). In 2014, the leading bond rating agencies significantly lowered the credit ratings of the Russian Federation, which, in fact, are an important indicator of the country's attractiveness to foreign capital. It is worth noting that nowadays the Russian economy is largely dependent on foreign capital. Whereas, the RTS and MICEX stock exchanges provide liquidity in large part due to attracting

foreign investment capital (Shevchenko 2017). The result of the reduction in the inward investment into the country's economy was a GDP deceleration in 2014-2016 from 1.8% to 0.5%.

The entire set of anti-Russian sanctions suggests the following directions for its implementation:

- 1) organizational and institutional sanctions, manifested in the suspension of Russia's membership in a number of international agencies.
- 2) individual sanctions, i.e. restrictions against senior officials (restrictions on entry and financial investments in banks of Western countries).
- 3) sets of sectoral sanctions against leading branches of the Russian economy. From July 16, 2014, the first economic sanctions of this kind were announced. Credit organizations such as Vnesheconombank, Gazprombank, Rosneft and Novatek oil companies, as well as enterprises of the defense industry, including Almaz-Antey, Izhmash, Uralvagonzavod, Concern Kalashnikov and others, got restricted. Then Russian Agricultural Bank, Bank of Moscow following by VEB, Sberbank, VTB were subjected to sanctions. They were not only forbidden to be credited to the US and the EU but also to provide services in these countries.
- 4) investment sanctions, i.e. the cancelation of investment cooperation, the cessation of financing for new projects in Russia.

As a reaction to imposed sanctions, the Russian Federation imposed an embargo on the import of certain types of agricultural products, raw materials and food from the United States, the EU and other countries supporting economic sanctions. Other counter-sanction actions by the Russian government were the following:

- prohibiting the entry into the country's territory to a number of politicians and statesmen of the United States and other countries;
- accelerating the work on putting in operation its own payment system (MIR);
- developing and implementing the accelerated import substitution program. Thanks to this policy, new enterprises are set up, focused on the production of high-tech products, which were previously imported;
- restricting the public procurement of consumer goods in Western countries.

The most damaging and negatively affecting of the Russian economy state are financial sanctions. The greatest potential for the emergence of threats for the country's economy is exactly in the financial and credit branch, the analysts say (Borisovskaya 2015; Osipov 2014). The fact is that the Russian banking system is so integrated into the world that foreign financial experts actually have access to key mechanisms for its management.

When analyzing the impact of financial sanctions on the economy of country subject to sanctions, it is necessary to take into account the impact not only of sanctions having a direct effect (restrictions on foreign borrowings by Russian issuers), but also of all other types of financial sanctions, including those having indirect and secondary effects. Indirect effects are due to a decrease in net capital inflow as a result of increased financial risks. Indirect effects have a large number of components, including reducing the borrowings of all other issuers, a decrease in the inflow of direct foreign and portfolio investments, and, possibly, an increase in the outflow of the Russian capital.

Secondary effects are connected with the economy reaction to a reduction in net capital inflow under conditions of an aggressive reduction in its import and even to a "stop of capital inflow" (SCI). This leads to a decrease in apparent demand, the decline in production, primarily due to a decrease in investment.

Today the global economy puts forward fundamentally new problems for science that cannot be resolved within the framework of the classical theory of sanctions, and require its transformation taking into account the adaptation to the rapidly changing conditions of the world economy. There is an urgent need, for example, to identify the conditions for achieving the efficiency of sanctions. In general, in the economic literature, the efficiency of sanctions is viewed in the context of achieving political goals and is determined by the threat or real damage to the economy and the unacceptability of such losses for the country.

In the context of an interconnected and interdependent world, there is a clear tendency towards the success of counter-sanction measures. Moreover, they are not always reflecting ones. This poses the question of identifying conditions under which sanctions can be efficient.

The evaluation of the international experience in the implementation of sanction pressure allows us to formulate the following conditions for achieving the effect of imposing economic sanctions:

- a significant degree of the country's import dependence in most sectors of the economy affected by the sanctions;
- limited opportunities to replace imported goods, both through the development of national production, and as a result of diversification of foreign economic relations;
- control of foreign economic operations in the country subject to sanctions by the countries imposing them, due to the geographical location and difficulty (impossibility) of products transportation, etc. (Osipov 2014).

In our opinion, the most important condition for achieving effects from the imposition of different sanctions is the heavy dependence of the state on external supplies of the most important goods, for example, food or consumer goods, and the impossibility of their rapid import substitution. Only in this case, various kinds of restrictions will be efficient. Although, the example of Russia clearly showed that the imposition of sanctions and the reactive food import embargo predetermined an active import substitution policy, which resulted in a significant increase in national agricultural production against the significant losses of European farmers (Figure 1).

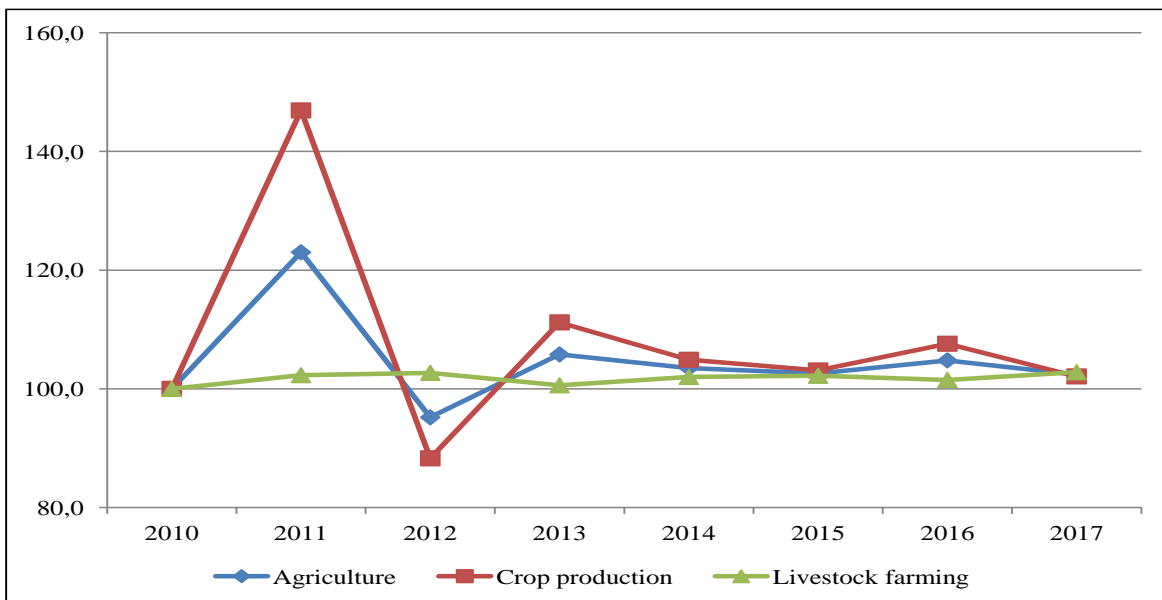


Figure 1. Production indices, % to previous year

There are other results of the import substitution policy. The dependence of the Russian food market on imports has significantly decreased (Table 2). In addition, import substitution policy at the initial stage usually causes an economic recovery.

**Table 2.** Share of Imports of Certain Products in the Total Pool of Russia’s Commodity Resources, %

Product	2013	2014	2015	2016
Meat and poultry, including byproducts	26.2	19.6	13.4	11.0
Beef, including byproducts	59.0	57.3	48.1	40.2
Pork, including byproducts	31.0	16.6	12.5	9.5
Poultry meat, including byproducts	12.8	10.0	5.5	5.0
Canned meat	20.0	13.7	9.0	9.1
Sausage products	3.2	2.2	1.0	1.4
Animal oils	35.9	34.3	25.5	26.3
Cheeses	48.0	37.3	23.3	22.8
Flour	1.5	0.9	0.8	1.9
Groats	1.8	0.5	0.3	0.2
Vegetable oils	19.0	14.4	17.4	16.3
Dried milk and dried cream	60.5	49.4	56.4	59.6
Confectionery	12.0	9.3	5.9	5.9
Sugar	8.2	7.4	6.2	5.5

Source: Russian Federal State Statistics Service (n.d.).

Another important direction in the transformation of the classical sanction theory is the need for better differentiation of losses and consequences of sanction interaction for countries that impose sanctions (political, economic, individual and other) from the consequences for countries that are subject to restrictions.

Factors that affect distribution of losses from sanctions are the following:

- the losses for the country subject to sanctions to a large extent are determined by its share in world GDP and the aggregate share of countries imposing sanctions;
- the degree of import intensity and dependence of production in countries, which are subject to sanctions and the possibilities of prospective import substitution;
- the economic efficiency of the management system in a country subject to sanctions.

To assess the impact of sanctions on the economic performance of Russia, E. Gurvich and I. Prilepskii constructed projected values for the two scenarios (with the oil price USD 100 and USD 50 per barrel), firstly assuming no sanctions, and then taking into account limited access to finance (Gurvich and Prilepskii 2016). The authors note that the impact of sanctions is enhanced by the fall in oil prices, as the loss records of capital inflows as a share of GDP increase. The consequences of sanctions are largely compensated (by about 40%) by a reduction in the Russian capital outflow. The total additional net capital outflow connected with sanctions can be estimated at USD 58 billion in 2014 and USD 160-170 billion in 2014-2017 (Table 3). According to the authors' calculations, sanctions against the Russian Federation have a rather painful impact on the real economy indicators: accounting only their financial components leads to a loss of 2.4% of the pre-crisis GDP in 2017 (with the oil prices of about USD 50 per barrel) at simultaneous reduction in investment and consumption. At the same time, a significantly more sensitive shock for the Russian economy was the fall in oil prices. According to economists, it leads to a loss of 8.5 percentage points of total growth during 2014-2017 (Gurvich and Prilepskii 2016).

**Table 3.** Assessment of the impact of sanctions on capital flows in 2014-2017, USD billion

Indicator	High oil price	Low oil price
Gross capital inflows	-276,0	-281,5
Debt obligation	-184,1	-184,1
Foreign direct investment	-79,5	-85,2
Obligations of public authorities	-12,4	-12,4
Gross capital outflow	-114,3	-113,2
Net effect of sanctions	-161,7	-168,1
Net effect of sanctions in % of GDP	-1,9	-2,8

Source: Gurvich and Prilepskii 2016

Expert loss estimations from financial sanctions in the Russian economy are the following (Gurvich and Prilepskii 2016; Regnum 2017; Shevchenko 2017; Shirov et al. 2015):

- European sanctions cost Russia EUR 23 billion in 2014 and about EUR 75 billion in 2015;
- net capital outflow caused by sanctions is estimated at USD 58 billion in 2014 and USD 160-170 billion for the period 2014-2017 by the experts;
- total losses of net capital inflow for this period amount 8% of GDP in 2013, accumulated losses of GDP are 6 percentage points of GDP in 2013.

In September 2015, Citigroup estimated the contribution of sanctions to Russia's GDP decline as of 10%, while the remaining 90% was caused by a fall in oil prices (Lenta.ru 2015). It can be concluded that the sanctions made only a minor contribution to the recession of the Russian economy: a more significant reason for weakening of the national currency and negative economic growth was the fall in oil prices. Nevertheless, the sanctions have undoubtedly caused some negative impact. They contributed to inflation, albeit to a much lesser extent than the weakening of ruble, which is dependent on oil price quotations. In addition, the Western investment inflow has declined significantly, with the exception of several large energy transactions. Since early 2014, Russian banks and industrial companies have had to pay about USD 250 billion of foreign debt. This is comparable to 20% of GDP at the current exchange rate. Obviously, this gravely affected the country's economy.

What are the consequences of imposing sanctions on the countries-initiators? The losses of the European countries from the sanction war between the West and Russia as of April 2017 amounted to about USD 100 billion over the past three years, which is twice the loss of Russia. Moreover, according to some analysts, most of the losses were not due to Russian counter-sanctions, but because of the Western sanctions themselves (Shevchenko 2017). The loss in income of the countries that imposed the sanctions is about USD 3.2 billion per month, while the losses of the Russian side are estimated at USD 52-55 billion, which is 1% of the country's GDP (TASS 2017).

The analysts of the French institute for research into international economics, Center d'Etudes Prospectives et d'Informations Internationales, hold to an opinion about the reverse impact of sanctions. In mid-2016, they estimated that only from the beginning of 2014 to June 2016, 37 countries that supported sanctions against Russia, received less than USD 60.2 billion (Expert online 2016). At the same time, 82% of all losses accounted for the export of products fallen within the scope of the Russian food import embargo. Researchers also concluded that the bulk of these losses are related specifically to the sanctions themselves, and not to the reactive food import embargo imposed by Russia.

The economy of Europe, and not of the United States, suffered most from the imposition of restrictions. The EU countries suffer 76.7% of all losses from trade restrictions with Russia. For example, Germany's losses in favor of continuing the policy are over USD 832 million per month (RIA Novosti 2016). This can be explained by the fact that the Nord Stream gas pipeline appears in Germany, and in the near future there are plans to lay the Nord



Stream-2. In addition, German enterprises were widely represented in the Russian market, which resulted in the largest impact. The reduction in the buying capacity of the Russian population was largely reflected in the German automobile concerns, in particular Volkswagen and BMW, which started their production in Russia.

Thus, Germany lost not only from the prohibitions on access to the Russian market, but also from the general reduction of this market as such. It should be noted that the largest relative share in trade flow with Russia fell to Germany, what is more for high-tech goods with high value added (RIA Novosti 2016). Other countries suffered significantly from the imposition of restrictions: France accounted for 5.6% of all losses, Britain had 4.1%.

The main outcomes of the impositions of sanctions for Russia became a significant reduction in the social standard of living, caused by the rise in price of imported goods (Figure 2) and the growth of user prices against the background of a reduction in salary, the growth of credit costs, a decline in business activity and economic stagnation.

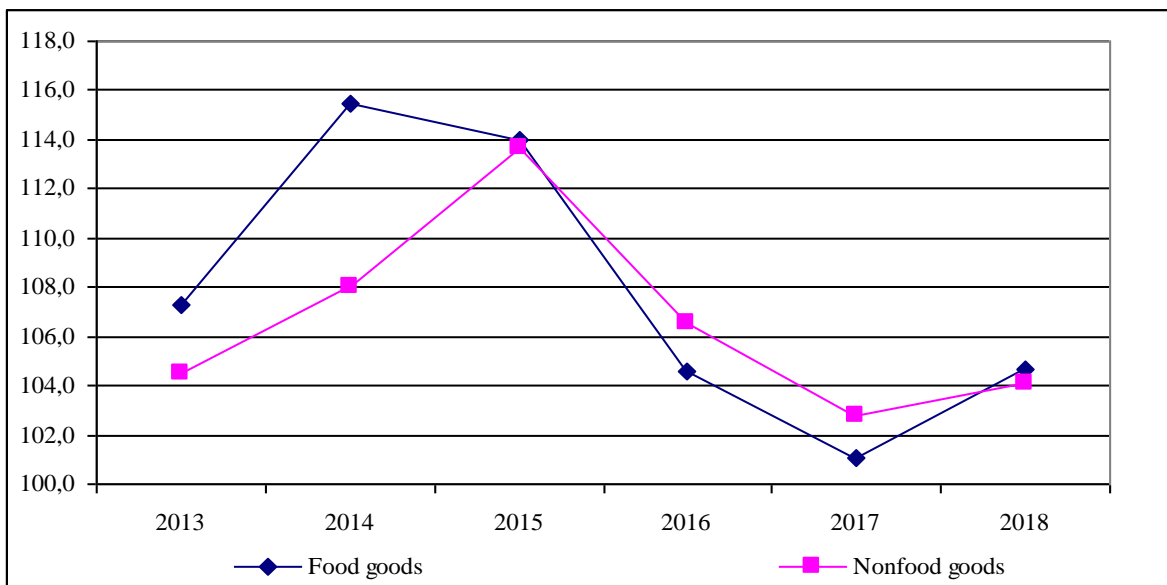


Figure 2. Consumer price index, % (December to December of previous year)

However, in addition to negative ones, there are certain positive aspects of the impact of sanctions on a number of branches. For example, Russian agriculture could significantly increase the volume of food production precisely due to European competitors exit from the market.

A logical consequence of the sanctions was the diversification of Russia's foreign economic ties and the gradual reorientation of Russia to cooperation with Asian countries, particularly with China. External trade turnover of these countries increased by 14.6 %.

#### 4. Discussion

In view of the foregoing, it is possible to identify the following directions of the transformation in the theory of sanctions:

1. To a larger extent, the losses for the country subject to sanctions are determined by its share in world GDP and the aggregate share of countries imposing sanctions. If in the world output the share of the countries imposing sanctions is small, they cannot have a significant impact on the development prospects of the country. In the case of Western sanctions against Russia (48 countries, whose share in the world gross product is about 60%), effective import substitution becomes practically impossible. The country subject to sanctions should ensure, in a

short period, the replacement of economically sound interactions on the world market with forced foreign economic ties.

2. Since sanctions in the global economy represent a severance of integration and cooperation ties, this cannot but affect the overall decline in labor productivity on a global scale and represents a refusal from the international division of labor. Thus, the losses from sanctions are sustained by all countries that somehow participate in sanctions and counter-sanction measures. An important outcome and negative consequence of sanctions is the deceleration in the overall growth rate of the world economy.

3. Another transformation direction of the theory of sanctions under modern conditions is the diversification process of types and forms of sanctions. The imposition of sanctions is increasingly important in the form of restrictions on individual sanctions, in the form of political restrictions of various kinds, restrictions in the form of non-admission to the largest events.

## 5. Conclusions and recommendations

The study of the countries' sanction interaction under the conditions of the existing global markets for goods and services, the enhanced international division of labor and the presence of other characteristics of the global economy make it possible to make a judgement on a duplicitous nature of economic sanctions both on the countries subject to sanctions pressure and those imposing sanctions. The negative reverse impact of sanctions on the countries imposing them should also be taken into account. The goals of the pressure applied are very difficult to achieve today, and the impact of sanctions can be small, as the country-subjects are gradually adapting to external challenges and threats.

A characteristic feature of the sanction policy implementation is the presence of significant overall losses, which are borne by the countries in the modern interconnected world from the severance of integration and cooperation ties. In fact, it is a blow to the theory and practice of the international division of labor, which ultimately reduces the costs of manufactured products, taking into account its production under the best possible conditions.

All of the above factors make us rethink the classical theory of sanctions and make new emphases in characterizing sanctions as an economic category and process.

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