

# EU Sanctions against Russia:

## Coherence and Efficiency after 12 Months of War

A Ukrainian Assessment

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## Executive summary

*The current sanctions regime imposed by the EU is unprecedented in scale and effects on the Russian aggressor. The deteriorating results of those restrictions on the military capabilities of the Russian Federation are undeniable. However, the existing sanction regime is not entirely flawless.*

*The complexities caused by the EU institutional approach, the scope of restrictions and extent of the economic relations to be severed, and the political implications of the international security crisis have made it hard to achieve the main goal of sanctions – forcing Russia to stop the war.*

*This paper, prepared by Ukrainian analysts, identifies several issues, which must be improved to make the sanction regime more efficient:*

- *Non-territoriality of the sanctions regime and continued operations of Western companies in Russia through their local subsidiaries.*
- *Loopholes caused by discrepancies between the different sanctions regimes (i.e., by the EU, US, as well as Japan, UK, and Canada).*
- *The uneven regime of export control for dual-use goods and military use of commercial products.*
- *Absence of restrictions towards many Russian entities belonging to military enterprises and the defense industry.*

*To tackle these problems, the Ukrainian authors propose **the following actions toward** key sectors of the Russian economy:*

- **Oil, gas, and oil processing industry:** *reconsider the price ceiling for Russian crude oil and suggest the escrow account model; change the legal approach towards foreign companies operating in Russia through their subsidiaries and prohibit companies from the EU to have commercial operations with the Russian oil enterprises.*
- **Manufacturing industry:** *tighten the liability for sanctions violation and introduce secondary sanctions against the intermediaries engaged in evasion schemes; impose sanctions against the biggest Russian enterprises constituting the vital source of revenue for the state budget; coordinate the imposition and implementation of the sanctions with non-EU partner countries in terms of substance, procedure and expected effects; and ban the European companies from any cooperation with the Russian entities if they are related or belong to the defense industry and/or sanctioned by Ukraine or one of the partners countries.*
- **Imports of technology and military production:** *enforce the export control up to the presumption of denial; expand the list of dual-use products in cooperation with partners; introduce the screening of potential intermediaries and shell companies applying for the export of dual-use products to Russia; impose sanctions on the military or military-civilian enterprises operating under the auspices of Rosteh, Roscosmos, Rosatom, and*

*Almaz Antey; impose sanctions on Rosatom, as proposed by the European Parliament resolution of 2 February 2023<sup>1</sup>.*

- **Banking sector:** *disconnect from the SWIFT system and other international transactional systems all Russian banks that provide services to state-owned companies, state and parastatal organizations, top Russian civil and military officials, including members of the Russian parliament; prohibit any cooperation between European banking service companies and Russian banks; withhold the export turnover of Russian companies in critical sectors (i.e., oil and gas) on escrow accounts.*

*This paper and commentaries were prepared thanks to our partner Eastern Europe Studies Centre, Vilnius, Lithuania.*

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1. European Parliament. (2023, February 2). Texts adopted - preparation of the EU-Ukraine summit - Thursday, 2 February 2023. europarl.europa.eu. Retrieved from [https://www.europarl.europa.eu/doceo/document/TA-9-2023-0029\\_EN.html](https://www.europarl.europa.eu/doceo/document/TA-9-2023-0029_EN.html)

# 1. General overview of the Russian economy under the sanctions regime

In the beginning of 2023, Russia is breaking records for the number of international sanctions, bypassing Iran with about 11 thousand restrictions imposed on it in various areas (8,984 individuals and 1,811 legal entities<sup>2</sup>). The EU introduced a large portion of the sanctions. The dimensions and effects of these restrictions are numerous and vivid. However, it is important to look at the following economic indicators to demonstrate the most significant developments.

The International Monetary Fund (IMF), the World Bank, and the Organization for Economic Cooperation and Development (OECD) expect that the Russian economy can shrink by 3.4-5.5 % in 2022 and by 2.3-4.5 % in 2023. In terms of GDP, the recent forecasts predict that the cumulative effects of sanctions will cause 7-8% of GDP decrease, which can be compared with the 1998 default and 2008 crisis levels<sup>3</sup>.

In the long term, potential economic growth is expected to be very low as Russia has shifted public spending to the military need, lost access to critical technologies, and bled out human capital because of brain drain. In addition, Russian companies have been cut off from the western financial markets<sup>4</sup>.

The introduction of sanctions led to a massive withdrawal of foreign companies from the Russian market<sup>5</sup>, a reduction in foreign exchange liquidity, and increased exchange rate volatility<sup>6</sup>. Russia has stopped publishing foreign trade statistics but Russian imports are estimated to have fallen significantly due to the war and sanctions<sup>7</sup>.

Representatives of the Russian businesses also confirm negative economic trends. Data from Russian sources<sup>8</sup>, which must be treated cautiously, show that 45% of small and midsize businesses acknowledged a drop in the effective demand of the population as a critical factor in the decline of revenues in 2022. In addition, 38% of respondents also mentioned difficulties with foreign economic activity because of the western sanctions.

Thus, the detrimental effects of the EU sanctions are non-disputable. However, there are loopholes and limitations nested in the specifics of EU sanction-enforcing mechanisms, as well

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2. Published by Statista Research Department, & 17, J. (2023, January 17). Sanctions imposed on Russia by target 2023. Statista. Retrieved from <https://www.statista.com/statistics/1293531/western-sanctions-imposed-on-russia-by-target/>

3. Simola, H. (2022, December 15). War and sanctions: Effects on the Russian economy. CEPR. Retrieved from <https://cepr.org/voxeu/columns/war-and-sanctions-effects-russian-economy>

4. Commerce-Treasury-State Alert: Impact of sanctions and export controls ... (n.d.). Retrieved from <https://www.bis.doc.gov/index.php/documents/about-bis/newsroom/press-releases/3172-2022-10-14-impacts-of-sanctions-and-export-controls-on-russian-military-industrial-complex/file>

5. Yale School of Management. (2023, February 5). Over 1,000 companies have curtailed operations in Russia-but some remain. Yale School of Management. Retrieved from <https://som.yale.edu/story/2022/over-1000-companies-have-curtailed-operations-russia-some-remain>

6. Kak sanktsiyi vliyayut na finansy Rossii: TSB nazval shest kanalov. Banki.ru. (2022, May 31). Retrieved February 6, 2023, from <https://www.banki.ru/news/lenta/?id=10967204>

7. Conteduca, F. P., Mancini, M., & Borin, A. (2022, November 9). The impact of the war on Russian imports: A counterfactual analysis. CEPR. Retrieved February 6, 2023, from <https://cepr.org/voxeu/columns/impact-war-russian-imports-counterfactual-analysis>

8. Republic.ru. (n.d.). Retrieved February 6, 2023, from <https://republic.ru/>

as a surprising agility and sustainability of the Russian regime and Russian economy.

On the one hand, the Russian economy found a “safety bag” in the national reserves and skyrocketing energy export revenues<sup>9</sup> in the first months after the invasion, mainly due to conducive market conjuncture. Coupled with the National Welfare Fund reserves, this money has been used to mitigate inflation and import decline, and limit the damage.

At the same time, the sanction regime has blind spots and weaknesses that Moscow managed to exploit successfully, especially in the light of the expertise in evasion that the Russian regime has acquired since 2014.

In this paper, the authors provide an analysis of some dimensions of the EU restrictions concentrating on specific sectors, which are considered emblematic and illustrative in terms of the sanctions’ efficiency and loopholes.

Specifically, the authors look at the critical sectors of EU sanctions application, namely, Russian oil and gas industry, manufacturing industries, import of technologies, and banking sector, with their specifics and issues. The authors develop proposals to solve the highlighted issues.

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9. Ministry of Finance of the Russian Federation - the Russian Government. (n.d.). Retrieved February 6, 2023, from <http://government.ru/en/department/69/>

## 2. Sectoral dimensions of the sanctions

### 2.1. Oil and gas, oil processing industry

The sanctions against Russian oil and gas sectors are the most emblematic and significant in the EU's history, as well as relevant due to the Russian dependency on energy revenues. In 2021, oil and gas accounted for 49% of all export revenues (243.8 billion dollars)<sup>10</sup>. The share of oil and gas revenues in the federal budget was 36% (9 trillion rubles)<sup>11</sup>. As the primary source of income, these sectors are critical to Russian financial stability and military capabilities. The EU sanctions are even more important in this respect, as Europe has always been a huge sales market for Russian oil. In 2021 it accounted for 50% of the country's total exports (111.2 million tons)<sup>12</sup>.

As part of the sixth package of EU sanctions, Brussels finally introduced an embargo against Russian oil, with several reservations and an incremental implementation procedure<sup>13</sup>. The oil embargo and its effects are coupled with the G7 oil price ceiling. Additional complications are caused by the ban on the European operators from transporting Russian oil by sea. Moreover, all the gas pipelines transporting Russian gas to Europe are now either shut down (Nord Streams, Yamal) or used at minimal capacity (Ukrainian gas transportation system).

Consequently, the European market, which absorbed almost 2.5 million barrels of oil per day, another 1 million barrels of oil products, and 155 billion cubic meters of natural gas, has practically disappeared for Russia<sup>14</sup>. The Indian and Chinese markets, though availing in this situation, still cannot digest additional volumes of oil and gas. The complete overhaul of energy trade routes demands time and will likely come with enormous cost for Russia.

Despite the sanction regime, Russian revenues from the oil and gas industry remain high. According to the Russian Ministry of Finance, those amounted to 11,856.1 billion rubles in 2022<sup>15</sup>. Incomes from the different oil sectors did not reach record low, although a negative trend of profit reduction was observed. Moreover, there are numerous ways of sanctions evasion, such as oil blending to hide the country of origin or disabling the tracker and transferring from ship to

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10. Eksport Rossiyskoy Federatsiyi osnovnykh energeticheskikh tovarov. Bank Rossiya. (n.d.). Retrieved February 6, 2023, from [https://www.cbr.ru/statistics/macro\\_itm/svs/export\\_energy/](https://www.cbr.ru/statistics/macro_itm/svs/export_energy/)

11. Yevropa otkazhetsya ot 90% nefi, kotoruyuy pokupayet v Rossiya. S rossiyskoy ekonomikoy mozhno poproschatsya? Meduza. (n.d.). Retrieved February 6, 2023, from <https://meduza.io/cards/evropa-otkazhetsya-ot-90-nefti-kotoruyu-pokupaet-v-rossii-s-rossiyskoy-ekonomikoy-mozhno-poproschatsya>

12. Yevropa otkazhetsya ot 90% nefi, kotoruyuy pokupayet v Rossiya. S rossiyskoy ekonomikoy mozhno poproschatsya? Meduza. (n.d.). Retrieved February 6, 2023, from <https://meduza.io/cards/evropa-otkazhetsya-ot-90-nefti-kotoruyu-pokupaet-v-rossii-s-rossiyskoy-ekonomikoy-mozhno-poproschatsya>

13. Press corner. European Commission - European Commission. (n.d.). Retrieved February 6, 2023, from [https://ec.europa.eu/commission/presscorner/detail/uk/IP\\_22\\_2802](https://ec.europa.eu/commission/presscorner/detail/uk/IP_22_2802)

14. Lee, J. (2023, January 29). Russia can't replace the energy market Putin broke. Bloomberg.com. Retrieved February 6, 2023, from <https://www.bloomberg.com/opinion/articles/2023-01-29/russia-can-t-replace-the-energy-market-putin-broke>

15. Minfin Rossiya. (n.d.). Retrieved February 6, 2023, from [https://minfin.gov.ru/ru/statistics/fedbud/oil?id=57=122094-svedeniya\\_o\\_formirovani\\_i\\_ispolzovanii\\_dopolnitelnykh\\_neftegazovykh\\_dokhodov\\_federalnogo\\_byudzheta\\_v\\_2018-2023\\_godu](https://minfin.gov.ru/ru/statistics/fedbud/oil?id=57=122094-svedeniya_o_formirovani_i_ispolzovanii_dopolnitelnykh_neftegazovykh_dokhodov_federalnogo_byudzheta_v_2018-2023_godu)

ship to hide the country of origin<sup>16</sup>.

Finally, the oil servicing companies, not necessarily covered by the sanctions regime, have continued their operation in Russia, including those belonging to the so-called Great 4. The western oil servicing sector benefits from the fact that restrictions on process apply only to foreign legal entities. In contrast, the Russian subsidiaries of foreign companies can operate freely and avoid liability<sup>17</sup>.

For example, SLB (formerly known as Schlumberger), a global technology provider for integrated fossiliferous bed evaluation, well-site construction, mining management, and hydrocarbon processing, occupies 8% of the Russian oilfield services market<sup>18</sup>. On March 18, 2022, SLB company stated that it would suspend new investments and deployment of new technologies in Russia<sup>19</sup> according to the US sanctions legislation. However, the company has an extensive subsidiary system that allows it to circumvent sanctions imposed in 2014. The corporate structure of SLB involves around 11 intertwined companies featured in the Russian public procurement in the recent years, including after the start of the full-scale Russian aggression. SLB's businesses and subsidiaries work for government corporations with orders worth millions of rubles.

Another dimension of the energy sector is the oil refinement and processing industry, which is also essential. Although the EU has banned import of the Russian polymeric compounds of different origin and use, schemes of sanction evasion appeared quickly. For instance, the Russian Gavary Group<sup>20</sup>, one of the major exporters of Russian polymers, has been recorded to evade sanctions by exporting its products to Latvian subsidiary Softtech LLC<sup>21</sup> through one of its shell companies – LLC Ecopolymer<sup>22</sup>, also featured in the Russian state procurement. Yet again, the evasion is taking place and is only made possible thanks to straw companies in EU member states Latvia and Poland.

**Therefore, given the issues mentioned above, the following actions in the oil and gas industry sanctions should be implemented by G7 members and the EU:**

- Reconsider the price ceiling by G7 and suggest the escrow account model for the Russian oil export, where the net profit from purchase can be withheld upon meeting

16. Minfin Rossiya. (n.d.). Retrieved February 6, 2023, from <https://minfin.gov.ru/ru/statistics/fedbud/oil?id=122094-svedeniya-o-formirovani-i-ispolzovani-dopolnitelnykh-neftegazovykh-dokhodov-federalnogo-byudzheta-v-2018-2023-godu>

17. Durygina, L. (2022, March 21). Bez embargo no I bez servisa: Rossiya predrekli sokrashcheniye nefteobychi. NSN. Retrieved February 6, 2023, from <https://nsn.fm/economy/vyzhidatelnyaya-pozitsiya-uhod-nefteservisov-iz-rossii-sochli-popravimym>

18. Orekhova, A. (2022, August 16). Nefteservis bez aktsenta. Oilcapital.ru. Retrieved February 6, 2023, from <https://oilcapital.ru/news/2022-04-13/nefteservis-bez-aktsenta-1041863>

19. Schlumberger announces update on Russia operations. SLB. (n.d.). Retrieved February 6, 2023, from <https://www.slb.com/about/newsroom/press-release/2022/pr-2022-0318-update-on-russia>

20. Gavary Group (n.d.). Retrieved February 6, 2023, from <https://gavarygroup.com/>

21. Proverka i analiz rossiyskikh yuridicheskikh litz i predprinimateley (n.d.). Retrieved February 6, 2023, from <https://www.rusprofile.ru/>

22. OOO Ekopolimery. (n.d.). Retrieved February 6, 2023, from <https://www.rusprofile.ru/id/2727537>

certain conditions by the seller;

- Transform the legal approach towards foreign companies operating in Russia through the vast network of subsidiaries, and prohibit Western-affiliated legal entities from entering into commercial transactions with Russian entities;
- Strengthen the liability for sanction evasion by third parties and introduce secondary sanctions against the intermediaries in the evasion schemes.

## 2.2. Manufacturing industries

Although oil and gas account for the most significant portion of Russian income, the export-oriented manufacturing industries loom large in the overall structure of Russian export, with the European market as the end consumer. The main sectors affected by sanctions are metalworking, wood industries (export-oriented ones), and machine building.

According to the Russian Ministry of Industry and Trade estimates, sanction restrictions affected the export of 3.9 million tons of finished rolled products, 200,000 tons of pipes, and 700,000 tons of steel blanks, with a total value of about \$3.7 billion. At the same time, the giants (of non-ferrous metallurgy) — Norilsk Nickel and Rusal — continue to sell their products worldwide<sup>23</sup>.

The Russian timber and steel producers have yet to find alternative export markets that offer favorable price levels. As a result, production fell sharply in these industries and companies suffered heavy losses<sup>24</sup>.

The automotive industry is also slowing down: in the first half of 2022 alone, car sales fell by 58% compared to the same period in 2021<sup>25</sup>. In 2022, there were component shortages at the Russian car plants, and all European, American, and Korean companies left the Russian market. As a result, the number of remaining brands has decreased from 60 to 14, including three Russian (Lada, GAZ, UAZ) and eleven Chinese automotive brands<sup>26</sup>.

Still, the Russian economy only faced the first real consequences of large-scale international sanctions in July 2022. "The real impact of the sanctions began in July when we saw a 17% drop in the logging industry and wood processing in July-August. In metallurgy, steel fell by 8-9%,"

23. RIA Novosti (2023, January 10). Chego zhdet stalevaram v 2023 godu? Prometall. Retrieved February 6, 2023, from [https://www.prometall.info/analitika/chego\\_zhdet\\_metallurgam\\_v\\_2023\\_godu](https://www.prometall.info/analitika/chego_zhdet_metallurgam_v_2023_godu)

24. Simola, H. (2022, December 15). War and sanctions: Effects on the Russian economy. CEPR. Retrieved February 6, 2023, from <https://cepr.org/voxeu/columns/war-and-sanctions-effects-russian-economy>

25. Российский завод Hyundai будет законсервирован. Motor.ru. (n.d.). Retrieved February 6, 2023, from <https://motor.ru/news/hyundai-russian-plant-18-10-2022.htm>

26. Как идет в россии замещение западных брендов. (n.d.). Retrieved February 6, 2023, from <https://www.avto.vesti.ru/finance/article/3131968>

rolled metal fell by 10%. According to the August statistics, the sanctions worked in the summer and influenced the contraction of industrial production," said Natalya Zubarevich, acclaimed Russian economic geographer<sup>27</sup>.

This phenomenon is partially explained by the reserves of spare parts and machine tools stockpiles, which started to drain only by mid-summer 2022. Secondly, the seemingly civilian character of these enterprises shields them from the international restrictions, despite their active involvement in the military production and contribution to the Russian state budget. Also, the continued presence of the Western companies which supply the machine tools and servicing, contracted or acquired before the full-scale invasion, constitutes a critical problem. This is an issue because the lists of sanctioned enterprises differ significantly between the EU, USA, and other countries, which protects European companies from any liability.

For instance the Italian Danieli, one of the world's three most prominent suppliers of equipment and installations for the metalworking industry, is actively represented in Russia<sup>28</sup>. The company is a flagship of the bilateral Russian-Italian trade relations and operates in the Russian market with the knowledge and active support of the Italian government<sup>29</sup>. Clients of Danieli are the giants of the Russian metalworking industry. Some actively cooperate with the Russian military-industrial complex (Severstal<sup>30</sup>, MMK<sup>31</sup>, UMMC<sup>32</sup>, KUMZ<sup>33</sup>) and are under US sanctions (Severstal)<sup>34</sup>. However, the majority of these companies are not sanctioned by the EU, despite unveiled cooperation with the Russian defense industry and their role as essential taxpayers and supporters of the Russian regime.

So far, Danieli has not announced any exit from the Russian market, termination of investments or new projects, restriction of the business activity, or any other form of reduction of presence

27. Акулов, А. (2022, November 20). Аналитик Зубаревич: воздействие санкций на экономику России началось с июля, но худшее - впереди - газета.Ru: Новости. Газета.Ru. Retrieved February 6, 2023, from <https://www.gazeta.ru/business/news/2022/11/20/19077985.shtml>

28. Innov\_action to be a step ahead ' Danieli. Innov. (n.d.). Retrieved February 6, 2023, from <https://www.danieli.com/en/>

29. Первый Российско-Итальянский алюминиевый форум. Итоги. Новости металлургии - Металлоснабжение и сбыт. (2021, July 7). Retrieved February 6, 2023, from <https://www.metainfo.ru/ru/news/127577>

30. 35media.ru. (n.d.). "Северсталь" участвует в укреплении обороноспособности страны - 35медиа. 35 Медиа. Retrieved February 7, 2023, from <https://35media.ru/news/2020/05/09/severstal-uchastvuet-v-ukreplenii-oboronosposobnosti-strany>

31. "КАМАЗ", П. А. О. (2016, October 6). "КАМАЗ", "ММК" и "ВИСТ Групп" обсудили перспективы сотрудничества. ВПК.name. Retrieved February 6, 2023, from [https://vpk.name/news/165135\\_kamaz\\_mmk\\_i\\_vist\\_grupp\\_obsudili\\_perspektivy\\_sotrudnichestva.html](https://vpk.name/news/165135_kamaz_mmk_i_vist_grupp_obsudili_perspektivy_sotrudnichestva.html)

32. ТАСС. (2015, August 7). Авиаполк на урале получил четыре транспортно-пассажирских самолета L-410. ВПК.name. Retrieved February 6, 2023, from [https://vpk.name/news/137847\\_aviapolk\\_na\\_ural\\_e\\_poluchil\\_chetyre\\_transportno-passazhirskih\\_samoleta\\_l-410.html](https://vpk.name/news/137847_aviapolk_na_ural_e_poluchil_chetyre_transportno-passazhirskih_samoleta_l-410.html)

33. Трифонова, Полина (2019, July 17). Структура "реновы" с партнерами запустила крупный завод алюминиевых сплавов. Ведомости. Retrieved February 6, 2023, from <https://www.vedomosti.ru/business/articles/2019/07/18/806760-kamensk-uralskii-metallurgicheskii-zavod>

34. Counter narcotics designations; Russia-related designations and update; issuance of Russia-related general licenses. U.S. Department of the Treasury. (2022, October 21). Retrieved February 6, 2023, from <https://home.treasury.gov/policy-issues/financial-sanctions/recent-actions/20220602>

in Russia. The company also continues to recruit employees in Russia and implement various projects across the country.

**Therefore, the EU can take several steps to constrain Russian manufacturing industries:**

- Implement sanctions against the major Russian enterprises that do not belong to the defense industry but remain vital sources of revenue for the Russian state budget.
- Coordinate introduction and implementation of the sanctions in terms of substance, procedure, and expected effects between the EU, USA, UK, Canada, Japan, Australia and other countries with regard to Russian manufacturing companies.
- Ban the European companies working with key enterprises in the Russian manufacturing industry from new projects, investments, and activities in Russia if they are working with the Russian defence and security sectors.

### **2.3. Import of technologies and military production**

The Russian dependence on technology and high-tech components produced by the EU and American companies is critical in the military and civilian production. Therefore, since the beginning of the full-scale invasion, the EU export of dual-use goods to Russia has been drastically curtailed, and the export control regime has taken the strictest form.

However, Russia effectively exploits loopholes in the export control for dual-use products introduced by different EU countries.

It must be said that qualifying items as dual-use goods is a complex issue in all jurisdictions. Moreover, the Russian companies have adapted to use civilian products for military purposes.

This is an urgent issue, since there is growing evidence of how Russian producers use commercial microelectronic products in the defence equipment. For example, in December 2022, RUSI released a study which reveals a global network of suppliers of Western electronics to Russia<sup>35</sup>. Supply of commercial semiconductors to be used in the defense industry go through intermediaries in Hong Kong (PRC), Turkey and even Estonia (both EU and NATO member), closing gaps for the Russian military.

At least 56 unique components were found to have originated from European companies. Notably, the most significant volume of products came from Netherlands-based NXP Semiconductors NV and Switzerland-based STMicroelectronics. Other manufacturers include Switzerland's u-blox,

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35. Reports, S. (2022, December 13). The supply chain that keeps tech flowing to Russia. Reuters. Retrieved February 6, 2023, from <https://www.reuters.com/investigates/special-report/ukraine-crisis-russia-tech-middlemen/>

Germany's EPCOS and Gumstix, and France's Thales Group <sup>36</sup>.

Since Russian authorities try to conceal involvement of the state and private companies in cooperation with the army and defence industry, it is hard to prove and prepare legal arguments to include these Russian entities into the sanction list.

For instance, the Ukrainian intelligence obtained access to documents confirming Rosatom's involvement in supplies for the Russian defense industry, demonstrating the company's participation in the war<sup>37</sup>. So far, Rosatom, the state-run nuclear industry holding, has escaped sanctions over potential economic fallout and because of its extensive involvement in the civilian nuclear power industry across the globe, including in the EU. The documents show that Rosatom's subsidiaries provided aluminum oxide, a vital component for missile fuel, to the Russian defense industry. The documents show that other goods include:

- Lithium-ion batteries to power banks, missile defense systems, and other armaments;
- 3D-printing technology;
- Chemical compounds used in aircraft and missile engineering.

It also must be remembered that Rosatom directly participated in illegal and criminal takeover of the Zaporizhzhia nuclear power plant, Europe's largest.

Another dimension of the flawed sanctions regime concerning military enterprises is the complex and intertwined structure of the Russian defense industry.

The umbrella state companies are already sanctioned but their numerous subsidiaries are not. For instance, the following defence enterprises are still exempt from the sanctions:

- Sokol Plant LLC, Saratov Aviation Plant CJSC (repair of air-guided missiles R-27),
- JSC "Izumrud" (installation and adjustment of ships' artillery fire control system),
- RT-Komplekt LLC (supply of components for the Russian aviation, instrument-making and shipbuilding industry),
- JSC "NVP "Topaz" (production of hardware and software for controlling ground and ship aircraft basing),
- OJSC "Order of Labor Red Banner All-Russian Research Institute of Radio Equipment" and JSC "EVT Association" (maintenance of means of communication, radio technical support of flights and control system of the Air Force),
- Lipetsk Mechanical Plant LLC (manufacturer of transport units for anti-aircraft missile

36. Byrne, J., Baker, J., Reynolds, N., Watling, D. J., Byrne, J., & Somerville, G. (2022, August). Royal United Services Institute. <https://rusi.org/>. Retrieved February 6, 2023, from <https://static.rusi.org/RUSI-Silicon-Lifeline-final-web.pdf>

37. Belton, C. (2023, January 20). Russia's State Nuclear Company AIDS war effort, leading to calls for sanctions. The Washington Post. Retrieved February 6, 2023, from <https://www.washingtonpost.com/world/2023/01/20/rosatom-ukraine-war-effort-sanctions/>

systems S-300, S-330BM and S-300VM "Antey-2500"<sup>38</sup>.

Finally, there are critical import materials, which must be prohibited because of their dual use. For instance, fermium is used in producing hulls, structures of armored vehicles, ships, missiles, elements of jet engines, magnetic contacts, relays, and switches necessary to produce hermetic magnetically controlled contacts<sup>39</sup>.

**Therefore, the authors urge the EU institutions and member states to implement certain measures to tackle the mentioned issues:**

- Strengthen the export control for dual-use goods up to the presumption of denial, where the export of dual-use items are prohibited assuming military use until the exporter proves the opposite.
- Expand the list of dual-use goods and products falling under the export control in cooperation with non-EU countries;
- Introduce screening of the potential intermediaries and shell companies applying for the export of dual-use goods in terms of possible relation to Russian defense industry enterprises;
- Impose sanctions on Rosatom and military or military-civilian enterprises operating under Rosteh, Roscosmos, and Rosatom, Almaz Antey, since they continue to play a critical role in maintaining Russian military capabilities.

## 2.4. Banking sector

The Russian dependency on the western payment systems, banking technologies (including cryptography and authentication systems), and the critical importance of unimpeded financial transactions for the commodity trade make the Russian banking system one of the key targets for the new restrictions.

The EU's toolkit against the banking sector includes freezing of assets of the financial institutions and the prohibition of any transactions, including disconnection from the SWIFT international payment system. In addition, Russian banks may be prohibited from issuing Eurobonds and new shares (in particular, such restrictions were imposed on Alfa Bank)<sup>40</sup>.

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38. The International Working Group on Russian sanctions. Freeman Spogli Institute for International Studies. (n.d.). Retrieved February 6, 2023, from <https://fsi.stanford.edu/working-group-sanctions>

39. #9, W. G. (n.d.). Sanctions Working Group #9- Sanctions Evasion.pdf. Google Drive. Retrieved February 6, 2023, from <https://drive.google.com/file/d/1HIXUBLnPrdRNR8-b9X6Z-MInafGZ2FAC/view>

40. Kakiye banki popali pod sanktsiyi na segodnya. (2022, December 22). Retrieved February 6, 2023, from <https://gogov.ru/news/886013-22dec22>

The purpose of the restrictions was to reduce revenues and freeze assets of the Russian banks so that they could not use them to support the regime or lend money to producers of military equipment. In this respect, almost a quarter of the banking system of the Russian Federation (82 banks) suffered losses in 2022, mainly large banks<sup>41</sup>. In February 2023, the following Russian banks were disconnected from SWIFT: VTB, Rossia, Otkrytie, Novycombank, Promsvyazbank, Sovcombank, WEB.RF, Sberbank, Rosselkhozbank, Moscow Credit Bank<sup>42</sup>.

At the same time, it should be taken into account that the disconnection of the Russian banks from SWIFT does not limit their ability to make payments in foreign currency but only slows down the process and makes it more expensive due to the appearance in the operations of intermediate banks of third countries.

In addition, disconnecting only some Russian banks from the SWIFT system weakens the effect of the sanctions since these banks can open accounts in other Russian banks that are not under sanctions to continue their operations. There are visible signs of adaptation and development of alternative systems, such as the Russian SPFP and the Chinese CIPS<sup>43</sup>.

Another problem is the continued operations of the European banking service companies, which provide technical maintenance and secure operations to the Russian banking system.

One of the most vivid examples is OpenWay Group, a multinational company developing and delivering the Way4 system based in Belgium, which supports the Russian payment system "MIR," introduced after Visa and Mastercard's exit from the Russian market. Russian customers of the OpenWay Group include many sanctioned entities such as Sberbank, Alfa Bank, and VEB. RF, Russian Regional Development Bank, VTB Bank, Bank of Moscow, Rosneft, Lukoil (Licard), etc. Operating through several Russian subsidiaries and shell companies in Malta, the OpenWay Group tries to deny any connection with the Russian banks under sanctions. Still, in April 2022, Maltese company OpenWay Holdings Ltd sold its stake in the subsidiary Openway Service LLC (St. Petersburg, Russia) to its Russian management, which is deemed as a fictitious redistribution of assets. At the same time, the OpenWay Group's subsidiaries are contractors in numerous ongoing Russian public procurement projects. Yet again, such actions are possible due to the non-territoriality of sanctions and their vague wordings, allowing for the operations' continuation.

**Therefore, the authors urge EU institutions and member states to take a number of actions against Russian banking system:**

- Disconnect the rest of the Russian banks (i.e., Gazprombank) from the SWIFT system

41. Koshcheyev, S., & Gubayeva, L. (2023, January 2). "My poluchili naiboleye silnyy udar": itogi 2022 goda v ekonomike i na finansovykh rynkakh. *Realnoye vremya*. Retrieved February 6, 2023, from <https://realnoevremya.ru/articles/268849-ekonomika-i-finansovye-rynki-itogi-2022-goda>

42. Kakiye banki otklyuchili ot Swift v Rossiye. (2023, January 4). Retrieved February 6, 2023, from <https://gogov.ru/news/887248-6may22>

43. Visa ne nuzhna: kak alternativnyye platezhnyye sistemy dlya rossiyan operezheyut konkurentov. *Shares Pro*. (n.d.). Retrieved February 6, 2023, from <https://sharespro.ru/content/idei/visa-ne-nuzhna-kak-alternativnyye-platezhnyye-sistemy-dlya-rossiyan-operezhayut-konkurentov-76437/>

and other transactional systems.

- Ban any cooperation between the European banking service companies and the Russian banks.
- Withhold the export turnover of Russian companies in critical sectors (i.e., oil and gas) on escrow accounts.

## Conclusion

The number of sanctions introduced by the EU against Russia can be considered unprecedented. The constant increase of the sanction pressure plays an important role in limiting Russian military capabilities. Despite the complex institutional architecture and strict adherence to its internal procedures, the EU has demonstrated sufficient flexibility and readiness to respond jointly to new challenges. This approach proves that support for Ukraine remains strong and European solidarity is steadfast.

However, from the Ukrainian perspective, there are serious problems that the EU must address to improve the existing regime of sanctions and restrictive measures against Russia:

- Non-territoriality of the sanctions regime and continued operation through the subsidiaries of the major Russian private and state companies that play a critical role in supporting the aggression against Ukraine.
- Loopholes in the sanction regime caused by discrepancies between the different international partners (in particular, EU and US).
- The uneven regime of export control for dual-use goods and military use of commercial products.
- Absence of restrictions towards many Russian entities belonging to the defense industry.

The recommendations suggested above can be used to mitigate the flaws of the existing sanctions regime. However, the sanctions alone can never significantly alter Russian actions and destroy its military capabilities quickly. Therefore, the sanctions' pressure must be coupled with extensive military and financial support for Ukraine.

**Commentary to "EU Sanctions against Russia: Coherence and Efficiency after 12 Months of War. A Ukrainian Assessment"**

## Dr. Maria Perrotta Berlin

The international effort to help Ukraine win the war and repel the Russian aggression necessarily requires with high priority continued military aid as well as financial support to the country. But another complementary element is represented by the sanction regime imposed on Russia.

Sanctions as a tool of international relations are commonly used to influence the behavior of other countries or entities. As such, their historical record is at best mixed. A review by Hufbauer et al. (2009) examines all sanction episodes during the 20th century, and reaches the dismal conclusion that sanctions were successful at reaching their stated political objective in barely a third of cases (70 out of 204). The likelihood of success in affecting a political outcome varied of course with what the specific intended outcome was as well as what regime was in place in the target country. The ability to stop a military aggression, for example, was among the least frequent.

However, sanctions have statistically speaking undeniable economic consequences. Looking at historical cases, when damage to GDP could be accurately measured it is typically estimated that there was on average a 2-4% decrease in annual growth for an extended period of time, lasting on average for 10 years and up to 3 years after sanctions were lifted. This is very important. In the context of the ongoing war, and more generally in the face of such aggressive imperialistic tendencies as Russia displays, it is essential to limit the resources, both military, technological, and economic, that the country commands to carry out this and future potential attacks of similar character.

There is more to it. This is also a war of information and disinformation, fought with propaganda and alternative narratives. The sanctions and their impact affect public opinion, internationally as well as inside Russia. Russian propaganda, including presidential speeches, make a big point of claiming the sanctions don't work. Internally, this fills the obvious function of hiding and denying the disastrous consequences of the war, and fits well with the common narrative of Western decline, reflecting the tale that Western countries are struggling to maintain their economic, political, and cultural dominance. Even in the presence of biased propaganda and information censorship, most studies suggest that sanctions have a negative impact on the population of targeted countries, which are likely to be directly perceived and objectively felt. They include shortages of essential goods like food, clean water, medicine, and healthcare (see a review of studies in Berlin, 2022). They cause discontent and unrest in the population, which under specific circumstances may lead to protests and even the overthrowing of responsible regimes. Because of the dearth of reliable statistics and information, it is difficult to gauge from outside exactly how much the shortages due to sanctions are felt by the Russian population at the moment, and in what ways everyday life is affected. However, an analysis of observable factors speaks of long-term consequences, that will likely put the country on a permanently inferior growth trajectory (Berlin and Roine, 2022). As for the public opinion and discontent among the elites, there are of course continuous speculations, but the likelihood and potential outcome of a coup or regime overthrow are very hard to foretell.

Internationally, the claims to deny the effectiveness of sanction try to foment fatigue in the

West, and win allies in the South. After a year of war, and when other issues compete for voters' attention, including the high inflation and economic downturn that were sparked by the war itself, some commentators claim that public opinion in the West will tire of the conflict in Ukraine and start resenting the use of taxpayers' money for military and financial aid. There are as yet no clear signs of this, rather the opposite might be true. Many were positively surprised by the unity and decisiveness of response within the EU, within NATO, and the larger group of Ukraine's international allies, and found therein an impetus to rally around their flag. The fear is though that public opinion might turn if the perceived sacrifices associated with supporting Ukraine are portrayed as in vain, based on claims such as that Russia is not hurt by the European oil embargo, for example, or not as much as consumers in EU countries are hurt by the increased electricity prices. Similarly, in the global South, where the United Nations are now warning of several negative developments, including food shortages caused by the war and dwindling foreign aid budgets linked to the economic downturn, as well as other humanitarian crises, the Russian propaganda sees an opportunity to blame this all on the situation in Ukraine. Low- and middle-income countries that already felt neglected within the international community during the Covid pandemic may sympathize with this view. A gaping chasm in the UN general assembly and other important international fora risks undermining progress in many undertakings that today require a broad global support, including climate goals and global health, but also the very same issue of threats to international order, as posed by Russia's behavior. It is therefore fundamental, also for these reasons, that the economic consequences of both the war and the sanction regime are correctly portrayed, within Russia, within the sanctioning countries, and all around the world.

A factually correct perception of the effectiveness of the sanction regime can also improve the international support and alignment to it. Langot et al. (2022) show how important it is to include as many countries as possible in the sanction regime, in terms of the difference that broader participation implies for the costs to Russia. Improving the sanctions' actual effectiveness, besides perceptions, and adding to their consequence is of course another margin to work on. Here, the role of oil and gas is considered preeminent, because of the large share of Russian GDP and state budget represented by these commodities. The price cap strategy chosen by the allies is paying off, even if export quantities seem little affected. Wachtmeister et al. (2022) make the forceful point that this system, while allowing western oil servicing and shipping companies to continue operating, erodes the profit margins for oil producers, because of the lower sales prices they are subject to and the larger transport costs, and therefore also the tax base on oil sales. This implies lower profitability for future investments and slower prospecting, as well as, importantly, squeezed tax revenues and state budget in the medium to long run. The largest beneficiary of this approach would though be oil importers, in particular China. China can now use the cheap Russian crude for its own military and economic purposes, while also selling off any excess supply, after erasing the chemical fingerprints of the origins through refining and thus pocketing the much higher (at the moment almost double) international oil price. Given Beijing's strategic aspirations and growing confrontational foreign policies, it is a matter of contention as to whether the West should permit such a bolstering of China's capabilities. Therefore it is worth

considering the alternative of an escrow account approach to oil and gas trade, as proposed by the authors. This involves the continuation of trade with Russia at market prices, however withholding part of the revenues (for example, those in excess of the current price cap). A third-party intermediary would hold these funds until Russia has fulfilled some obligations -- the authors are not explicit, though, about what such obligations would be. One advantage of this approach is represented precisely by this growing pool of money with the potential to incentivize desired Russian behavior. Incidentally this would also lower global energy prices by relaxing quantity restrictions, and reduce the boon that current Russian oil importers are enjoying, including China. It is however unclear what conditions Russia might be persuaded to submit to, and how to enforce them, given the country's repeated lack of respect for international agreements and commitments.

Besides oil and gas, Langot et al. (2022) also show, through simulations, that limiting export to Russia has way larger potential to bring down GDP growth than purely curbing import from Russia. In this respect, the sanction regime is already supplemented by the broad boycott that western companies and multinationals voluntarily subscribed to. The authors point to several reasons why this still falls short. Among others, the same purposefully complex ownership structures and financial networks that in peacetime abet fiscal evasion and money laundering, make it now difficult to enforce sanctions and help entities to evade them (Nyreröd et al. 2022). A radical approach to deal with many of these issues is advocated for example by the International Working Group on Russian Sanctions – a Cold War 2.0 approach. This would entail a “negative list” approach to sanctions, identifying specific activities or entities that are excluded from sanctions and permissible, and licensing them on a strict case by case basis, rather than listing all prohibited activities or entities. In other words, a negative list identifies what is allowed, while everything else is not allowed. There are several advantages to using a negative list approach for sanctions:

A negative list approach can provide clarity and simplicity by clearly identifying what is allowed – everything else is prohibited. This can make it easier for individuals and businesses to comply with the sanctions, as they are only explicitly permitted, and even need to be licensed, to do exactly what is allowed to do. The boycott shows that this type of unambiguity is in demand for corporations, that don't like to deal with risk and grey zones. This can also make it easier for authorities to enforce the sanctions, as there is a clear and concise set of rules to follow.

A negative list approach allows for less flexibility, removing the need to constantly identify new prohibited activities or entities as they arise to evade and go around current sanctions. This way, a negative list approach can help prevent entities from evading sanctions by exploiting loopholes or engaging in similar activities that are not explicitly listed as prohibited. By identifying specific activities or entities that are allowed, a negative list approach can help prevent unintended consequences and ensure that the sanctions are effective. This can be particularly important in fast-changing industries or political environments, where new risks may emerge quickly and require an immediate response.

A negative list approach can be more efficient than a positive list approach, as it focuses on identifying few permissible activities or entities. These would be centered on strictly humanitarian needs, for example. This can save time and resources, both for those implementing the sanctions and those affected by them, and contribute a more positive image for the sanction regime as a whole by highlighting the components of international trade more directly linked to the needs of the population.

Overall, it is though still important to ensure that there are effective enforcement mechanisms in place to ensure compliance with the sanctions.

**In summary, improving and expanding the sanction regime is an important complement to other means of supporting Ukraine. Sanctions have important economic consequences that limit Russia's resources and space of maneuver in continuing its senseless war of aggression, or planning new ones. Two proposals going in the direction of increasing the effectiveness of the sanction regime are the use of escrow accounts for oil and gas trade, to add economic incentives and reduce external effects of the price cap, and a negative list approach to sanctions, to make them more comprehensive. The perception and narratives about the impact of sanctions also have a powerful impact on public opinion and indirectly affect the collective endeavor to support Ukraine and its success.**

## Dr. Toms Rostoks

Russia's full-scale military invasion of Ukraine on 24 February 2022 was a game changer for the EU and NATO. In anticipation of the invasion, the threat of economic sanctions was used as a deterrent against Russia's invasion. Although Russia was warned before the war that it would face serious consequences in case it would invade Ukraine, it nevertheless chose to proceed with its plan of invasion. The fact that Russia did invade Ukraine, provides clear evidence that economic sanctions as a deterrent against war failed. This is hardly surprising because economic sanctions are hardly likely to deter a determined adversary who has a clever plan how to win quickly against a supposedly weaker opponent. Russia's was plan envisaged a military operation with an aim to topple Volodymyr Zelensky's government in Kyiv, paving the way for eventual annexation – partial or total – of Ukraine in late summer 2022<sup>44</sup>. In retrospect, Russia's war plan was based on flawed assumptions about the ability of its own military to conduct such an operation and Ukraine's ability and determination to fight back. Russia's war plan, however, was also based on the assumption that it would be able to evade Western sanctions if it won a quick victory against Ukraine and presented the EU and NATO with a *fait accompli*. Thus, the threat of economic sanctions could not succeed because Russia seemingly had a plan on how to avoid the economic costs of its military aggression against Ukraine.

This short commentary aims to provide a general assessment of the challenges that the EU and NATO face in exerting economic pressure against Russia. The sanctions that have been levelled against Russia are truly unprecedented in two ways. First, the severity of sanctions exceeds economic coercion that has been exerted against any target state in recent decades by far. Second, economic sanctions against Russia are also unprecedented in recent history because of the size of the target state's economy and the extent of economic interdependence between Russia and the world. The combination of these two aspects makes implementation of economic coercion against Russia particularly challenging. The subsequent sections elaborate on the challenges that (mainly) the EU and NATO have faced in applying economic pressure on Moscow. These range from the challenge of synchronizing cooperation and coordination of sanctions among the sending states to difficulties arising from domestic pressures on Western governments. The challenges related to Russia's adaptation to economic sanctions are also addressed.

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44. Zabrodskyi, M., Watling, J., Danylyuk, O.V., Reynolds, N. Preliminary Lessons in Conventional Warfighting from Russia's Invasion of Ukraine: February-July 2022. RUSI report, 2022. Available at: <https://static.rusi.org/359-SR-Ukraine-Preliminary-Lessons-Feb-July-2022-web-final.pdf>

## Limited effects of economic sanctions

The invasion and the ensuing Ukrainian heroic resistance caused an outcry in the West. Sanctions that were threatened before the invasion were less than the sanctions that were actually imposed after Russia's invasion. Cutting Russia off the SWIFT system was probably as far as the threat of sanctions went before the invasion, but the actual sanctions that were imposed went far beyond what was threatened before the war. In their efforts to curb Russia's ability to finance the war effort, sanctions were imposed upon Russia's Central Bank, and the Nord Stream project was pronounced dead shortly after the invasion started. This was compounded by the 'chilling effect' that prompted Western companies to announce their exit from the Russian market *en masse*. This might seem surprising but, in fact, it is not. Political decisionmakers may find it difficult to anticipate their own interests and actions in novel situations that they have not been able to fully comprehend before they happen.

Although the initial damage to Russia's economy seemed catastrophic, Russian government managed to stabilize the situation soon. High energy prices played a key role in this, and European states were paying billions of euros to Russia for gas and oil deliveries while Russian troops were committing atrocities in Ukraine. As the result, sanctions that were imposed upon Russia are truly unprecedented, but much remains to be done in terms of implementation and enforcement. This is the key conclusion that Olena Yurchenko, Ilona Khmeleva, and Anton Mykytiuk have reached in their assessment of Western sanctions against Russia<sup>45</sup>. They point out that sanctions against Russian companies should be expanded and that Western companies should be prohibited from doing business with Russian companies. That conclusion is valid, but the limited effects of unprecedented sanctions need further explanation as to why the effects have been limited and what factors may account for this outcome.

Although some initial assessments were optimistic regarding the potential impact of economic sanctions on Russia's economy and ability to finance its war effort<sup>46</sup>, later assessments were less upbeat. András Rácz, Ole Spillner, and Guntram Wolff conclude that the economic consequences of economic sanctions for Russia's economy were less damaging than expected and that "Ukraine's allies need to maintain, tighten, and adjust sanctions to further weaken Russia's military and economic power as it adapts to them"<sup>47</sup>. A study authored by Andrew David, Sarah Stewart, Meagan Reid, and Dmitri Alperovitch concludes that Russia has to some extent adapted to Western economic sanctions and that it has established new supply chains for integrated circuits and other products that are crucial for its military industry<sup>48</sup>. Falling oil and gas prices

45. Yurchenko, O., Khmeleva, I., Mykytiuk, A. 2023. EU Sanctions against Russia: Coherence and Efficiency after 12 Months of War – Ukrainian Assessment.

46. Sonnenfeld, J., Tian, S. 2022. Actually, the Russian Economy Is Imploding. Foreign Policy, 22.07.2022, <https://foreignpolicy.com/2022/07/22/russia-economy-sanctions-myths-ruble-business/>

47. Rácz A., Spillner O., Wolff, G. 2023. Russia's War Economy: How Sanctions Reduce Military Capacity. DGAP Policy brief, 14.02.2023. Available at: <https://dgap.org/en/research/publications/russias-war-economy>

48. David, A., Stewart, S., Reid, M., Alperovitch, D. 2023. Russia's Shifting Import Sources Amid U.S. and Allied Export Restrictions. Silverado Policy Accelerator, <https://cdn.sanity.io/files/0wfzc71x/production/6745ea42c21d65d6709231e0e7767bd5de57469b.pdf>

in early 2023, however, have resulted in reduced oil and gas revenues, raising questions about the ability of Russia's economy to withstand external economic pressure<sup>49</sup>. In short, although economic devastation has been less than expected, long-term prospects for Russia's economy are bleak. Economic sanctions, however, may not have decisive impact on Russia's ability to continue its war effort against Ukraine in the short-term.

### **Why have the effects of sanctions been limited?**

Three sets of factors have played a key role in determining the limited effect of Western economic sanctions. First, economic sanctions against Russia are unprecedented. On the one hand, economic sanctions that were imposed in the wake of Russia's invasion of Ukraine will have a devastating effect on Russia's economy, as will the war itself. It is not just economic sanctions that are biting, but also the loss of hundreds of thousands of young Russians who have left the country either early on after the start of the 'special military operation' or after V.Putin announced partial military mobilization in September 2022. Catastrophic loss of life during the war will further exacerbate Russia's economic difficulties. In short, disconnecting Russia from the Western economies will reduce Russia's economic potential in the medium- and long-term.

On the other hand, the unprecedented nature of the economic sanctions is also somewhat problematic because there is no playbook for such sanctions. Some aspects of economic punishment were never seriously considered until early 2022, and little was known of their potential effects on Russia's and Western economies. This aspect partially explains why the initial optimism about the likely effects of economic sanctions turned out to be wrong. This is in direct contrast to sanctions that were imposed upon Russia in 2014. These earlier sanctions were limited, but their economic effects were also targeted and intentionally limited<sup>50</sup>. The effects of sanctions against Russia that were imposed since February 2022 are harder to predict. It can be assumed that their impact will have negative economic consequences for Russia, but there is less certainty about the extent of the impact. Thus, cause and effect relationship in economic sanctions against Russia is hard to predict. Maximizing the effects of economic sanctions requires constant finetuning because Russia is trying to minimize the negative effects of sanctions.

Second, successive adoption of sanctions' packages by the EU has been subject to extensive internal debates between the member states. In fact, this has been the case not just with the economic sanctions but also with the military assistance. Russia's invasion of Ukraine prompted a united response of the EU and NATO, but the pace at which individual member states were ready

49. Ministry of Finance of the Russian Federation. 2023. Предварительная оценка исполнения федерального бюджета за январь 2023 года, 06.02.2023, [https://minfin.gov.ru/ru/press-center/?id\\_4=38368-predvaritelnaya\\_otsenka\\_ispolneniya\\_federalnogo\\_byudzheta\\_za\\_yanvar\\_2023\\_goda](https://minfin.gov.ru/ru/press-center/?id_4=38368-predvaritelnaya_otsenka_ispolneniya_federalnogo_byudzheta_za_yanvar_2023_goda)

50. Christie, E.H. The Design and Impact of Western Economic Sanctions against Russia. The RUSI Journal 161:3, 2016, pp. 52-64.

to proceed and the extent of economic sanctions was a contentious subject. In retrospect, some of the measures that were adopted should have been adopted sooner, but in that case, they might have threatened internal cohesion of the West. The EU and NATO had to respond quickly to Russia's aggression, but moving too quickly might have shattered the internal consensus, risking the long-term ability to proceed with more sanctions against Russia and military assistance to Ukraine. Also, the economic consequences of sanctions for the EU member states had to be considered, minimizing the negative effects for the EU economy<sup>51</sup>. Disproportionate negative effects for some EU member states would cause discord among the sending states. This would exacerbate domestic pressures on some EU member states' governments that might be tempted to scale down sanctions to avoid domestic criticism. To avoid the loss of momentum behind economic sanctions, it was better to proceed cautiously and carefully build domestic and EU-wide coalitions that would be capable to pursue further sanctions if that would be necessary and rigorously implement them.

Third, the limited effects of economic sanctions also have much to do with Russia's desire to avoid the detrimental effects of economic sanctions, as well as V.Putin's ability to ensure that the Russian society absorbs the high economic costs of the war against Ukraine. The public pronouncements of the Russian president at the start of the war when Ukraine was accused of posing grave threats to Russia were false, but over time the military conflict began to pose an existential threat to V.Putin's regime. A loss in war against Ukraine may undermine V.Putin's regime. The stakes are high, and Russia will try to rally its people to support the war, withstand the economic costs of the war, and evade sanctions as much as possible. Ukraine fights for its survival as a sovereign nation-state, but losing the war will also undermine the future of V.Putin's regime. Thus, it will try to reorient its economic relationships from the West to Asia, Africa, and Latin America, as well as partner with some of its neighbours to evade sanctions. Russia may succeed in this endeavour because it is highly motivated, and some of its partners see this as an opportunity to enrich themselves. Sanctions evasion will not ensure Russia's access to all technological components that its military and civilian industries need to keep the Russian economy afloat, but they can ensure that Russia persists in the face of Western economic pressure long enough for the war to be decided on the battlefield rather than by the inability of the Russian economy to sustain the war effort.

From the normative perspective, economic sanctions should be strengthened and implemented more vigorously. The explanatory perspective, however, provides a clearer understanding of the challenges that reduce sanctions' effectiveness. Three factors stand out in particular: the unprecedented character of sanctions against Russia, the difficulties that effective international and domestic cooperation among actors entails, and the existential character of the war for V.Putin's regime. To be clear, these are hurdles that can be dealt with rather than insurmountable obstacles, but maximization of sanctions' effects on Russia's economy will remain a constant concern as long as economic pressure will be applied against Russia.

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51. European Council. 2023. EU sanctions against Russia explained. Available at: <https://www.consilium.europa.eu/en/policies/sanctions/restrictive-measures-against-russia-over-ukraine/sanctions-against-russia-explained/>

## Vytautas Kuokštis

The authors analyse EU's sanctions on Russia, covering both the implemented measures as well as certain deficiencies of the sanctions' regime and, consequently, suggest how the sanctions can be expanded and improved.

They correctly note that the current sanctions' regime "is unprecedented in scale and effects". Indeed, as also pointed out in the paper, Russia has surpassed Iran as the most sanctioned country in the world. Due to the unprecedented nature of the sanctions it has been – and continues to be – rather difficult to provide precise forecasts regarding their effects. The lack of precedent has to do with the scope and depth of the sanctions as well as the nature of the target – a large and relatively developed economy.

The academic literature on sanctions has for a long time focused on whether sanctions "work" – i.e., whether they tend to achieve the intended goals. Some authors claim that they often do not, which would raise the puzzle of why sanctions are imposed in the first place. Others retort, however, that measuring effectiveness depends on what the exact goal is. If the goal is to change the target's major policy or, even more ambitiously, the target's political regime, then indeed most sanctions historically have been a "failure". Nonetheless, there can be other goals, such as signaling a political position and deterring future undesirable behavior by the target and especially others or by weakening the target's economic capabilities in the longer run, making it more difficult for the target to pursue actions that are opposed by the senders.

Seen in this light, it would be hard to describe the EU's (and "the West's" more generally) sanctions towards Russia as ineffective or a failure. Certainly, forcing Russia to stop its war and retreat from Ukraine would be the most desirable effect of the sanctions but this was never a scenario with a high chance of coming to fruition, especially in the short run. Thus, one could disagree with the authors' assertion that a number of factors "have made it hard to achieve the main goal of sanctions – forcing Russia to stop the war". In fact, even if all the additional measures proposed by the authors (and perhaps yet other steps) were implemented, it would be hard to expect that Russia would discontinue its efforts due to those sanctions. On the other hand, I would concur that, as the authors point out, sanctions did have an important effect on Russia's economic prospects and its ability to wage war, and yet, at the same time, "the sanctions alone can never significantly alter Russian actions and destroy its military capabilities quickly", and continued military support for Ukraine is vital.

The authors provide a good overview of a number of important areas of sanctions, including the energy sector, manufacturing, and finance. They also thoroughly identify a number of gaps in the sanctions regime and propose numerous ways of how these gaps can be closed or at least narrowed. These policy proposals can be of important value to officials considering the future development of the sanctions. Furthermore, it is correctly pointed out that the coordination between different actors imposing sanctions is of primary importance.

One area which has not been covered in the report has to do with Russia's currency and how it has been affected by sanctions. Initially, the ruble depreciated very sharply, with panic settling

in the Russian financial market, and a potential risk of a severe financial crisis. However, the situation was subsequently stabilized due to the effective measures by the Russian Central Bank as well as the West's chosen particular approach to sanctions. The latter emphasized restrictions on exports to Russia, while still largely leaving major imports from Russia intact – due to the perception that time was necessary to find alternative sources of energy. Given a significant reduction in imports and the high value of exports (sustained by the high price of gas and oil), in 2022 Russia saw a very considerable expansion of its trade surplus – it is thus only natural that the ruble strengthened. At the same time, one must point out that, contrary to Russian propaganda and misconceptions expressed by some commentators, a stronger ruble in and of itself was neither a sign of the Russian economy's strength nor that the sanctions "did not work". Instead, it was a result of the initial asymmetric nature of the imposed sanctions in terms of the emphasis on exports versus imports. Indeed, with the West imposing an embargo on oil imports and the price ceiling, the ruble again started weakening at the end of 2022-beginning of 2023.

One aspect worth considering is the potential of certain tradeoffs regarding actions taken by the EU. Imposing sanctions always carries costs and benefits, and there are also questions of sustainability and political feasibility. In general, I am in full support of toughening the sanctions' regime but one might question whether, given that there will usually be some level of opposition to stronger sanctions, some political capital and effort might be spent on other areas, in particular stronger military and economic/financial aid to Ukraine. Of course, these different sets of actions are not mutually exclusive and can (and indeed have been) pursued simultaneously – my only remark is that this is something to potentially take into account, in case a situation arises where one has to decide on which course of action is likely to bring the largest benefit for Ukraine.

Finally, I fully agree with what I take to be one of the authors' key messages, namely that one needs to engage in constant learning and adaptation of the sanctions' policy. With time, the target's regime and economic actors in the targeted country learn to find ways to adapt and mitigate the sanctions' regime (in economics' parlance, elasticities are larger in the longer run). Therefore, there is a need for constant thorough monitoring of the regime's implementation and potential loopholes. This report serves as a valuable piece of information in this endeavor.

## Dr. Rebecca Harding

### **Introductory remarks – why economics and trade matter in modern conflict**

The attempt to constrain Russia using economic rather than direct military means is a test case in the use of trade and commerce strategically to constrain the actions of another state. Trade has become a tool of the ‘all means’ approach to warfare in a Great Power conflict that is multidimensional and multinational in origin. These are characteristics that derive from the interdependencies between nations that developed through the post-Cold War era of globalisation<sup>52</sup>.

The battle lines are drawn, not just between Russia and the “West” (the United States, NATO, the European Union and allies such as Japan, South Korea, Taiwan and Australia), but also between China and the “West”. They are drawn across finance, technology, commodities such as oil and wheat supply chains, and increasingly over human rights, climate change. As such, these battle lines challenge the very nature of market economics and trade itself. In short, who we do business with, how we do business and what that business entails, has become the concern of national strategy in a way that has not been seen on this scale before; in short, trade has become strategic as the concept of military power alone has diminished in importance.

This is the battle for the 21<sup>st</sup> Century. Nation states are using trade to balance their domestic and foreign policy interests in a world where the prospects for Mutually Assured Destruction (MAD) has limited the prospects for direct military confrontation between great powers. Although as we can see with Russia at present, the nuclear peace is fragile. So how do Nation States protect national interests, build power and constrain aggression in an adversary and can it ever be successful?

### **The challenge of using sanctions**

The authors focus on the EU sanctions against Russia and to this extent highlight the institutional complexities and economic consequences of the measures taken in Europe rather than globally. However, they correctly point out in their introduction that the scale of sanctions is unprecedented and targeted at reducing the military capabilities of Russia both in its current actions in Ukraine, and in the future as well.

The global response is being exercised through sanctions, export controls, access to technology and access to financial markets and has several goals: to starve Russia of access to revenues, foreign currency, inward capital flow and technology in order to restrict the flow of cash to its military immediately and its investment in military R&D and weapons development in the

52. Henry Farrell, Abraham L. Newman; Weaponized Interdependence: How Global Economic Networks Shape State Coercion. *International Security* 2019; 44 (1): 42–79. doi: [https://doi.org/10.1162/isec\\_a\\_00351](https://doi.org/10.1162/isec_a_00351)

future; to isolate Russia geoeconomically and to act as a deterrent to further action because of this exclusion and isolation.

It was never the intention to destroy the economy because this would have handed a propaganda victory to the Putin Regime – that harsh economic times were caused by Western aggression and therefore an act of “all means” warfare. Russia’s strategic culture is one of disruption<sup>53</sup> and grievance<sup>54</sup> and Mr. Putin’s February 21<sup>st</sup> speech, suggested that the Russian economy was adapting to its new reality even while the military campaign was being prioritized<sup>55</sup>.

The extent to which Russia has been constrained is almost impossible to measure. External economic data seems to have remained remarkably robust. Russia’s GDP slowdown appears to have been just 2% last year according to the IMF, with projected growth of 0.3% in 2023<sup>56</sup>. Inflation has apparently remained under control after an initial spike that was addressed with a base rate spike of 20%, and the Ruble has remained strong in international currency markets because of the capital control measures that the Central Bank of Russia implemented almost immediately.

Yet there is a likelihood that the numbers used by the IMF for their calculations are based on misleading data emanating from Russia itself, and potentially boosted anyway in 2022 by the spike in energy prices, greater military production and a plunge in imports due to the sanctions themselves<sup>57</sup>. This could be construed as part of its information war – Russia shut down its publication of economic data in April 2022<sup>58</sup>. But what it does mean is that any interpretation of economic impact of the sanctions has been difficult to assess from the outset.

What is clear, however, is that there has not been an end to the fighting in Ukraine. It has turned into a war of attrition. Given that the West is itself constrained by the need to limit the risk of nuclear confrontation, the question now is how the sanctions regime can be tightened further to limit Russian military action now and in the future.

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53. Rumer and Sokolsky (2020): ‘Etched in Stone: Russian Strategic Culture and the Future of Transatlantic Security.’ <https://carnegieendowment.org/2020/09/08/etched-in-stone-russian-strategic-culture-and-future-of-transatlantic-security-pub-82657>; [https://carnegieendowment.org/files/Russian\\_Strategic\\_Culture\\_Rumer\\_Sokolsky.pdf](https://carnegieendowment.org/files/Russian_Strategic_Culture_Rumer_Sokolsky.pdf)

54. <https://www.diplomaticcourier.com/posts/understanding-russian-strategic-culture>

55. <https://www.easternherald.com/2023/02/21/putin-russia-will-not-act-on-the-principle-of-guns-instead-of-butter/>

56. <https://www.imf.org/en/Countries/RUS>

57. Agathe Demarais (March 13th 2023): ‘Don’t Trust Russia’s Numbers: Moscow has made economic statistics a part of its information war.’ Foreign Policy. [https://foreignpolicy.com/2023/03/13/russia-economy-sanctions-gdp-war-ukraine-disinformation-statistics/?utm\\_source=PostUp&utm\\_medium=email&utm\\_campaign=News%20Alerts&utm\\_term=73970&tpcc=News%20Alerts](https://foreignpolicy.com/2023/03/13/russia-economy-sanctions-gdp-war-ukraine-disinformation-statistics/?utm_source=PostUp&utm_medium=email&utm_campaign=News%20Alerts&utm_term=73970&tpcc=News%20Alerts)

58. <https://www.wsj.com/articles/russia-blocks-economic-data-hiding-effect-of-western-sanctions-11650677765>

## The Law of Unforeseen Consequences

The authors point to four main areas where sanctions could be tightened and aligned across the EU, and potentially beyond: oil and gas, manufacturing, technology and military production and the banking sector. These have so far borne the brunt of sanctions and there is still more that can be done in the form of Western business and commercial operations in Russia, closing loopholes in the sanctions regimes between allies, making export controls over dual-use goods and military use of commercial goods consistent, and taking out all Russian banks from the SWIFT financial system that have any relations with the Russian military or Russian government. The authors suggest a range of more sophisticated screening and pricing controls in all of these areas that would represent a stringent tightening of economic measures.

The challenge to the full effectiveness of a trade and sanctions regime rests in the nature of trade itself, however. This is the case for several reasons, not least of which is Russia's preparedness since 2014 for trade diversion to evade sanctions and similar economic measures which the authors acknowledge. But the real challenge rests in the nature of trade and supply chains which make them prone to fraud and money laundering: an example serves to illustrate the point.

The use of drones in the Russia-Ukraine conflict illustrates the case in point perfectly – drones are “cheap, deadly and made in China” according to Faine Greenwood<sup>59</sup>. However, their extensive use is not explicitly military – Aerorozvidka<sup>60</sup> has been working with individual hobbyists in Ukraine to self-assemble small drones for use against Russia since 2014; it is crowdfunded and initially consisted of IT enthusiasts but was a key part of the Ukraine defence against convoys of Russian tanks at the start of the conflict.

This may seem straightforward but according to Greenwood's research of 900 cases of drone use by Russians and Ukrainians in the last year, 59% of drones used by both sides come from one source: the Chinese-owned DJI with locations globally; the company reportedly used US as well as Chinese technologies in its manufacture until it was put on the US Entity list<sup>61</sup> in June 2021. DJI has withdrawn from both the Russian and the Ukrainian consumer markets, but the supply of drones is informal and funded by private individuals outside of the conflict zone. Ukraine remains better resourced than Russia, which has been reporting shortages.

There is a lot of ambiguity from a national security, and military, and even supply chain finance perspective in this brief illustrative overview, but it raises numerous, arguably unanswerable, questions. Are the drones as originally manufactured, military ones? How much US, UK or European technology do they contain and is this technology dual use or directly military? Are they a weapon in a conventional military context since they are being used for surveillance and

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59. Faine Greenwood (February 16th 2023): The Drone War in Ukraine is Cheap, Deadly and Made in China” <https://foreignpolicy.com/2023/02/16/ukraine-russia-war-drone-warfare-china/>

60. <https://www.theguardian.com/world/2022/mar/28/the-drone-operators-who-halted-the-russian-armoured-vehicles-heading-for-kyiv>

61. <https://www.theverge.com/2021/6/1/22463946/dji-drone-ban-pentagon-department-of-interior>

to drop grenades by non-state actors? Since DJI has the capacity to geofence (remotely to limit the reach of the drones geographically), does this mean that Chinese authorities are involved in supporting either Russia or Ukraine? Or does the fact that it hasn't used this capacity suggest it is neutral? If a large trade finance provider had at any point before the company was on the Entity list supplied letters of credit to DJI, could it have known the end users of these "consumer goods"? Or, more worryingly, can the source of funding be traced for their use in the current conflict given the challenges with tracking activity in deep-tier supply chains?

Implementing tighter sanctions regimes is a strategic objective that needs to be considered carefully. As the above example suggests, there are limitations in the extent to which data can be tracked down to the level, for example, of commercial goods used for military purposes, how they are funded and what their end use is. This has an impact on the banking sector in allied businesses and the likelihood is that the largest banks simply stop funding any activity that might present a compliance risk – this is certainly what has happened within the biggest banks since February 2022.

However, the economic impact globally is felt if all activity stops and while it may be the case that the largest corporates and organizations may halt their activity, smaller organisations will move to parts of the world where the sanctions regimes are not aligned at all; this helps to explain why we are seeing a shift of oil and gas businesses away from Geneva to places like Dubai and Hong Kong which do not comply with EU, US or UK restrictions on Russia to the same extent<sup>62</sup>. Russia is able to utilize these inherent weaknesses to evade sanctions<sup>63</sup>. As such, Russia had experience of the impact of sanctions in 2014 and given its determination to project its power in Ukraine, sanctions were never likely to have had much of an impact.

There will be a longer-term impact of sanctions on Russia's military capability if the determination of the EU and its allies to maintain and strengthen its access to technology and finance. However, an "all out" economic war like this has unforeseen consequences which will spill over into the global trading system: if we start to include commercial goods, such as drones, in our definitions of dual use goods, then the numbers of supply chains affected will expand. This is at the best of times difficult to monitor and control, but as the scope expands becomes almost impossible.

The second longer term consequence of sanctions is that it has the potential to bring Russia and China closer together. The West's "strategic competition" with China involves access to military

62. S&P Global Market Intelligence. (2022, October 26). <https://www.theguardian.com/commentisfree/2022/oct/26/sanctions-russia-war-ukraine-putin-oligarchs>

The impact of Russia's Invasion of Ukraine: A trade finance compliance perspective (2022, October): <https://cdn.ihsmarkit.com/www/prot/pdf/1122/Trade-Finance-Compliance-Perspective-Russia-Invasion-Ukraine-Impact-Oct-Update-Whitepaper.pdf?elq=36ef35de9e2f4a50834c6e88300fa559&elqCampaignId=49847&elqTrackId=107a594b89eb44b184cc12ea4fb58246&elqaid=172321&elqat=1>

63. [https://www.economist.com/finance-and-economics/2023/01/29/how-russia-dodges-oil-sanctions-on-an-industrial-scale?utm\\_content=article-link-1&etear=nl\\_today\\_1&utm\\_campaign=a.the-economist-today&utm\\_medium=email.internal-newsletter.np&utm\\_source=salesforce-marketing-cloud&utm\\_term=1/30/2023&utm\\_id=1467948](https://www.economist.com/finance-and-economics/2023/01/29/how-russia-dodges-oil-sanctions-on-an-industrial-scale?utm_content=article-link-1&etear=nl_today_1&utm_campaign=a.the-economist-today&utm_medium=email.internal-newsletter.np&utm_source=salesforce-marketing-cloud&utm_term=1/30/2023&utm_id=1467948)

technology and finance increasingly in the same way that it is using export controls, sanctions and industrial policy against Russia. It is likely that this will accelerate the development of the digital renminbi and the Russian and Chinese alternatives to the SWIFT messaging system.

In the end, support to Ukraine will have to include military hardware, economic, trade and financial measures to limit Russia's capacity to continue with the conflict in Ukraine. But this raises important questions about the "endgame". While it may be possible to engineer a ceasefire with appropriate economic and territorial gains for Ukraine, bringing Russia back into the global economic system is unlikely in the near future. In itself this may be a desired outcome, but it leaves Russia with a continued sense of grievance; and because it is in the nature of economic conflict that "war" is never declared and there is no cohesive strategy, it is equally the case that there may be no ultimate "winner".

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