IMPACT OF ECONOMIC SANCTIONS ON FOREIGN DIRECT INVESTMENT FLOWS

Unurmaa Dorjsuren[1] and Batchimeg Battsengel[2]

Abstract: *Global foreign direct investment (FDI) flows have gradually recovered following the Covid-19 pandemic. However, the impact of the international business and investment environment on FDI has been heightened by the crisis in Ukraine. The United States and the European Union (EU) have implemented stringent sanctions in an effort to swiftly halt Russia's military operations. These sanctions, imposed by the international community, are designed to exert pressure on the economies of Russia and its allies in order to bring an end to the conflict.*

The most impactful sanctions have been those targeting Russia's financial and energy sectors, resulting in immediate negative consequences for the country. In response, Russia has implemented retaliatory sanctions aimed at asserting its independence from the countries imposing sanctions.

In this article, we will analyze the changes in Russian FDI, with a particular focus on the effects of financial, energy, and trade sanctions.

Keywords: *Economic sanctions, FDI, flows, sanctions*

Introduction

Various countries around the world have utilized military force and other forms of pressure to impact the economy of a specific nation. Sanctions are designed to limit trade in the most vulnerable sectors of a country and to freeze the assets and travel rights of its elite individuals[3].

Foreign Direct Investment (FDI) plays a crucial role in many cases as it can replace imports and provide alternative sources of financing. However, it can also have negative consequences on the economy of a country facing sanctions, potentially leading to an increase in support from other sources. The case of Iran serves as an example of how economic growth can help a targeted country gain independence from sanctioning nations, strengthen its economy, alter trade networks, and diminish the intended effects of sanctions. While high-cost sanctions may have short-term impacts on FDI, these effects can be partially reversed in the long run.

There are various types of sanctions imposed by international organizations and certain countries. Political and diplomatic sanctions, economic sanctions, military and arms embargoes, prohibition of sports events, and prohibition on environmental issues are all forms of sanctions imposed by the international community.

Sanctions imposed by the international community

UN Sanctions are implemented when the five permanent members of the Security Council - the United States, China, France, Russia, and the United Kingdom - unanimously vote for or when the majority of the council supports the resolution. The most common forms of UN sanctions include

[1] *Lecturer SPSIRPA, National University of Mongolia*
[2] *Senior Lecturer, SPSIRPA, National University of Mongolia*

asset freezes and arms embargoes. The organization has imposed more than two dozen sanctions, often reflecting the interests of world powers.

EU Sanctions are imposed as part of the European Union's common external security policy. Due to the EU's lack of joint military power, economic sanctions are often the most powerful foreign policy tool used by European leaders. Since 1992, the EU has imposed more than thirty sanctions. Additionally, individual EU countries have the ability to take stronger measures independently within their own national jurisdictions.

US Sanctions: The United States leads the world in imposing economic and financial sanctions on other countries. Since the 20th century, over 110 sanctions have been implemented in an effort to destabilize governments and prevent armed conflicts. From 1960 to 2019, 29 countries and regions have been subjected to American economic embargoes.

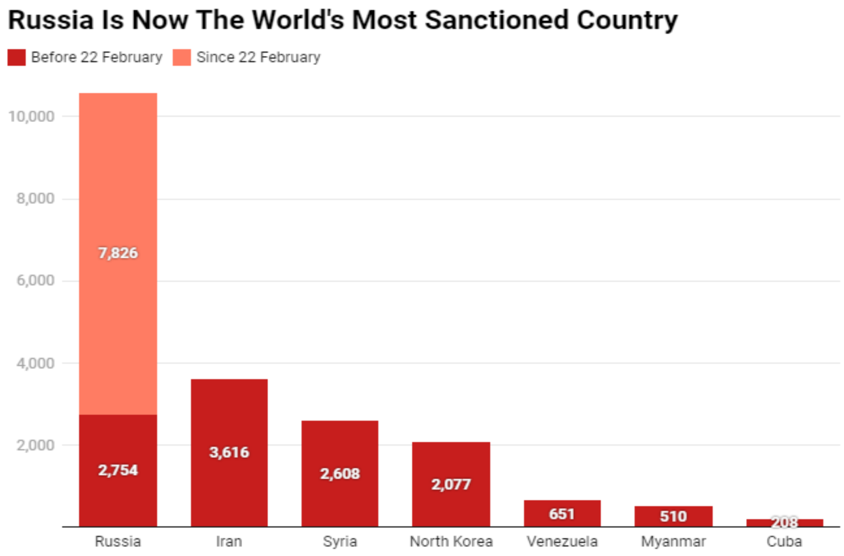
In 2019, the United States continued its trend of imposing sanctions on countries such as Cuba, North Korea, Iran, Sudan, Syria, and Russia. Additionally, more than 10 sanctions were targeted at individuals and entities involved in political crises and suspected criminal activities.

The use of sanctions as a tool of foreign policy by the United States has been a controversial topic, with critics arguing that they can have negative impacts on innocent civilians. However, proponents argue that sanctions are an effective way to pressure governments to change their behavior.

Successful Economic Sanctions:

The effectiveness of economic sanctions as a diplomatic tool has been demonstrated in various instances throughout history. One notable example is the case of the USA and the Netherlands in 1948-1949. Following the lifting of an embargo, the Dutch finally recognized Indonesia's independence, showcasing the impact of economic pressure on political decisions. Another significant instance occurred between the USA and India in 1965-1967. In response to the India-Pakistan war, the USA ceased military and food aid to India, sending a strong message against aggression and conflict. Similarly, in 1975-1976, the USA imposed an economic embargo on South Korea due to suspicions of the country purchasing raw materials from France for the production of nuclear weapons. Although the trade did not materialize, the sanctions served as a warning against engaging in such activities.

In 1976-1977, the USA discovered Taiwan's secret development of nuclear weapons and promptly banned the export of nuclear materials to the country. This action led Taiwan to abandon its nuclear weapons program, highlighting the success of economic pressure in preventing proliferation. Lastly, in 1992-1993, the USA and other countries imposed economic sanctions on Malawi to address democracy and human rights abuses. The pressure exerted by the sanctions ultimately led Malawi to establish a multi-party system through a referendum, underscoring the impact of economic measures in promoting positive change.



Source: Council of the European Union; US, Treasury Department

These examples illustrate the power of economic sanctions in influencing political decisions and promoting international norms, showcasing the importance of strategic diplomacy in achieving desired outcomes.

As a result of the global Covid-19 pandemic, countries around the world have been in quarantine for an extended period, leading to numerous challenges across various sectors. The economic impact has been significant, with foreign direct investment (FDI) flows plummeting by 42% in 2020, marking the lowest level since 1990. Total FDI inflows dropped from $1.5 trillion in 2019 to $859 billion in 2020. However, there was a strong recovery in FDI flows in 2021, with a remarkable increase of $1.58 trillion or 64%. The pandemic's effects were further exacerbated in 2022 by the crisis in Ukraine.

Russia, in particular, ranked 22nd among 202 countries as a major recipient of FDI and 22nd out of 172 countries as an investor. The crisis in Ukraine has caused a significant shift in the foreign policy direction of key players in the global economy, impacting investment flows. This uncertainty has had a negative impact on Russia's FDI in the short, medium, and long term. The full extent of the adverse effects of the war in Ukraine is yet to be determined, but much will hinge on the severity of sanctions and counter-sanctions imposed. The situation remains fluid, with implications for global FDI flows and the broader economic landscape.

In response to the military aggression, the United States, the European Union, Great Britain, Canada, Japan, Australia, and other nations have implemented unprecedented sanctions against Russia. These sanctions, similar to those imposed in 2014, target a wide range of entities within the Russian Federation, including individuals, government agencies, enterprises, banks, and NDCs. However, the current sanctions are more extensive than those put in place nine years ago and are expected to have significant implications for global foreign direct investment.

Sanctions against Russia

In response to the crisis in Ukraine that began on February 24, 2022, a series of sanctions have been imposed on Russia. The conflict between Russia and Ukraine has prompted various sanctions in the Western world, including the United States and the European Union, encompassing personal, economic, and financial restrictions[3]. According to Chepeliev, M., Hertel, T. W., & Van Der Mensbrugghe, D. (2022), in their article "Cutting Russia's Fossil Fuel Exports: Short-term economic pain for long-term environmental gain" published in The World Economy, Russia has become the target of the most sanctions globally due to the crisis in Ukraine in 2022. By the beginning of August 2022, approximately 12,000 sanctions had been imposed on Russia (Castellum.AI, 2022). Among these sanctions, Canada leads with 1,590, followed by Switzerland with 1,782, and the United States of America (USA) with 1,948 sanctions (Castellum.AI, 2022). The primary objective of these sanctions is to swiftly resolve the crisis in Ukraine by weakening Russia's economic capabilities, thereby limiting its ability to fund military expenditures. The majority of the sanctions significantly restrict direct investment opportunities in various sectors, including banking and technology. As a consequence of these sanctions, many countries are scaling back, rejecting, or even terminating business negotiations with Russia. While economic cooperation may not be completely disrupted, the sanctions undoubtedly impede fundamental activities between the parties, resulting in increased prices and costs.

Among the sanctions imposed, the most severe measure is the freezing of assets of Russian banks abroad, significantly impacting the flow of foreign direct investment (FDI). This measure includes a ban on large energy-related banks, which wield significant influence over the Russian economy. Promsvyazbank, a state-owned Russian bank primarily responsible for financing defense projects, along with three financial institutions - Otkritie, Novikom, and Sovkom - collectively holding assets worth $80 billion (£60 billion), play crucial roles in the Russian economy, as stated by the US Treasury Department[3] (The Guardian, 2022). Additionally, Sberbank Europe AG, a Russian state-owned subsidiary of Sberbank, served over 780,000 customers across eight European and Eastern European countries before being liquidated by the European Central Bank due to the Ukraine invasion (Reuters, 2022). The closure and asset freezes of these large banks, many of which are state-owned, have a detrimental impact on Russia's major transnational corporations (TNCs), potentially leading to industry shutdowns or bankruptcies. Moreover, it hampers the financial access of foreign investors within Russian territory.

1. **Financial Sanctions:** On February 26, 2022, the G7 countries (Canada, France, Germany, Italy, Japan, Great Britain, and the United States) along with the European Commission issued a joint statement denouncing Russia's aggressive actions and agreed to implement comprehensive economic and financial sanctions (European Commission, 2022).

Regarding Central Bank Assets, the US Treasury Department's Office of Foreign Assets Control (OFAC) under President Joe Biden's authority has taken steps to freeze the assets of the Central Bank of the Russian Federation in accordance with the International Economic Emergency Act. This order prohibits any transfer, payment, export, withdrawal, or other use of the Russian central bank's funds. Similarly, countries like France, Japan, and Germany have also frozen the assets of the Russian central bank.

The total assets of the Russian central bank are currently estimated at 300 billion US dollars, with nearly half of this reserve now inaccessible. Furthermore, restrictions have been imposed on the use of the direct investment fund amounting to USD 10 billion. The United States has frozen $38 billion, while other Western nations have also embargoed significant amounts of assets. For instance, Japan has frozen 33 billion US dollars of Russia's foreign currency reserves.

2. The swift payment system, a crucial component of international financial transactions, faced a significant shift on February 27, 2022. The European Union (EU), the United States, and their allies jointly announced their decision to exclude Russian banks from the Swift system, aiming to further isolate Russia from the global financial network. This move directly impacted Russia's main oil and gas exports, which heavily relied on the system for transactions.

The repercussions of these sanctions reverberated across various industries, causing disruptions in business and banking activities. With over 40 million messages transmitted through Swift daily, it is estimated that more than 1% of these transactions were linked to Russian payments. Despite initial hesitations, Russias largest bank, Sberbank, was eventually removed from Swift in June 2022, along with Credit Bank of Moscow and the Russian Agricultural Bank. This decision was part of a broader effort by the EU to isolate the Russian financial sector from the international banking system[5].The European Commission's announcement highlighted the exclusion of 10 Russian banks and 4 Belarusian banks from the Swift system, marking a significant escalation in the ongoing economic sanctions against Russia.

3. Government and Corporate Debt: On April 15, 2021, U.S. President Biden signed an executive order imposing new sanctions against Russia. Starting June 14, American companies were prohibited from purchasing bonds denominated in rubles. In 2022, the United States further restricted Russia's access to financing by blocking the Central Bank of Russia, the National Treasury, and the Ministry of Finance from issuing public debt.

This prohibition extended to the purchase of ruble and non-ruble bonds issued by these institutions, as well as granting loans to them. The same restrictions applied to the acquisition of short-term bonds, assets, and other financial instruments from the Treasury and other specified financial entities. The European Union also joined in by refusing to buy Russian bonds due to the perceived high risk associated with doing business with sanctioned entities and the potential for facing sanctions themselves. This ban also encompassed trading on the secondary market.

As a result of these measures, the external debt of the Russian Federation has decreased by $101.8 billion, reaching $380.5 billion, the lowest level since 2007. Of this total foreign debt, the amount owed in foreign bond loans is $36,218.2 million, accounting for 64% of the total. (Kostyaeva)

4. Energy sanctions have become a critical tool in the political game, particularly when it comes to Russia. The Russian economy heavily relies on the export of oil and natural gas, with these resources accounting for a significant portion of the country's budget and total exports. In fact, in 2021, oil and natural gas export revenue made up 45% of Russia's budget and 60% of total exports.

For example, Russia exported 750,000 barrels of diesel fuel per day to Europe in 2021, meeting 10% of the continent's demand. Additionally, Russia supplies about 40% of natural gas to EU countries. As a result, energy sanctions have been implemented to put pressure on Russia in various geopolitical conflicts.

In response to these sanctions, the USA quickly stopped its oil and natural gas imports from Russia due to its low dependence on these resources. However, the EU and other Western countries have taken significant steps to avoid supply shortages while still applying pressure on Russia. For instance, the EU banned all oil imports transported by sea and agreed to cut off 90% of Russian oil imports by the end of 2022.

In September 2022, the G7 countries, including the United States, Japan, Canada, France, Italy, Germany, and Great Britain, agreed not to sell oil above a certain price. To enforce this ban, they also decided to prohibit the transportation of oil sold at a price higher than the set limit[4]. These actions demonstrate the global effort to use energy sanctions as a strategic tool in international relations. The European Union has implemented a ban on new investments in Russia's mining industry, with the exception of certain raw materials. This decision was made during discussions between the EU and the G7 to prevent energy shortages and stabilize prices.

- As of December 5, 2022, the price of crude oil transported by sea has been capped at $60 per barrel.
- Premium oil products like diesel, kerosene, and gasoline have a price ceiling of $100.
- Additionally, fuel oil and naphtha will be priced at $45 per unit starting on February 5, 2023.

A recent study has shown that an energy embargo would result in significant macroeconomic losses for both the EU and Russia, leading to high inflation rates and global economic instability. This highlights the importance of carefully managing energy policies and trade relationships to avoid negative consequences for all parties involved.

5. Trade sanctions have significantly impacted the relationship between Western countries and Russia. In addition to restrictions on energy trade, various products such as iron, steel, wood, cement, coal, coke fuel, rubber products, seafood, and alcohol have been banned from import.

In 2021, EU-Russia trade reached 257.5 billion euros, making Russia the fifth largest trading partner after China, the United States, the United Kingdom, and Switzerland. However, by March 2022, trade had plummeted to 18.1 billion euros, and further decreased to 10.5 euros by September of the same year[4]. This drastic decline represents a 49% impact on exports and a 58% impact on imports due to the sanctions. Since the onset of the crisis, a total of 43 billion euros worth of goods exported to Russia and 91.2 billion euros worth of imported goods have been embargoed. The banned export products include crucial industrial and technological items such as radars, drones, camouflage gear, cameras, lenses, radio systems, and antennas, which are essential for Russia's economy and military operations.

Goods that include Western technology, such as semiconductors, oil refining technology, and aircraft parts, are crucial to the economy. However, they have been banned, along with EU banknotes. Additionally, a luxury ban has been implemented on high-demand items like pearls, jewelry, bags, purses, leather and fur goods, perfumes, antiques, porcelain, wine, champagne, and cigars.

Despite these restrictions, trade valued at less than 300 euros is still allowed. European clothing brands like Boggi, Benetton, Calzedonia, Etam, and Lacoste are among the companies that continue to operate in Russia. In fact, over 550 global companies, many of which are European, are still conducting business in the country.

The export of luxury goods under 300 euros and EU products such as coffee, cocoa, tea, toys, plants, wood, dyeing liquid, and soap is currently unaffected and proceeding as usual.

Types of Sanctions and Their Impact on Foreign Direct Investment (FDI)

Financial sanctions have a significant impact on FDI, particularly when it involves the freezing of assets of financial institutions. This action can have a dual negative effect on FDI, as seen in the case of Vienna-based Sberbank Europe AG, which faced liquidation partially due to such sanctions. This situation may also be replicated with other Russian banks in the future. Furthermore, the freezing of assets of major Russian banks can increase the risk for investors by limiting the movement of funds in and out of the country. This can lead investors to relocate their production from Russian territory due to the heightened risks involved. As a result, the structure of FDI is evolving, potentially paving the way for the steady growth of multinational corporations (MNCs) and large companies to dominate the Russian economy without facing significant competition. Despite the departure of many large European companies from Russia, there are still 550 European companies that continue to operate in the country.

In conclusion, financial sanctions play a crucial role in shaping the landscape of FDI and can have far-reaching implications for both investors and the Russian economy as a whole.

The recent withdrawal of four Russian and Belarusian banks from the SWIFT system has undoubtedly added complexity and increased costs to international business transactions. However, Russia has responded by establishing its own domestic financial messaging system, known as SPFS, under the guidance of the Central Bank of Russia. Interestingly, Iran, which has been excluded from the SWIFT system since 2018, has found a way to collaborate effectively within the SPFS framework.

President of the Central Bank of Iran, Mohsen Karim, has highlighted the potential for collaboration between Iranian financial institutions, approximately 700 Russian banks, and over 106 banks from 13 other countries, particularly those in the Eurasian region. Notably, on March 20, 2023, ROSSWIFT announced plans to create a union that will bring together various market infrastructure participants, including SPFS, SWIFT, and CIPS of the Bank of Russia.

In response to Western (US) capital market restrictions on financing Russian public debt and the purchase of Russian bonds, Russian state-owned multinational companies are expected to face indirect operational challenges. However, the impact of these bans in the United States is considered to be relatively moderate. Since 2021, efforts have been made to reduce reliance on dollars and euros in favor of increasing liquidity in the Russian ruble. Consequently, the amount of Russian debt owed to the United States has decreased significantly, reaching its lowest level in recent years.

Energy sanctions have been imposed on Russia, with the US cutting off all energy supplies and the EU reducing its supplies by 90%. These sanctions come at a high cost, causing significant changes in the structure of Russia's energy exports. Despite this, Russia still manages to find alternative markets to supply its energy.

These costly sanctions have a short-term negative impact on the Russian economy, affecting foreign direct investment (FDI) flows. However, in the long run, Russia may become less reliant on Western deposits, leading to economic growth and restructuring of partnerships. This could open up opportunities for diversifying sources of economic power.

In terms of trade sanctions, the disruption of the EU-Russia trade network has forced Russia to seek substitute products from other countries and explore new investment opportunities. This has prompted Russia to expand its investments and markets in partner countries, adapting to the changing trade landscape.

Trade Sanctions: The disruption of the EU-Russia trade network allows Russia to attract substitute products from other countries and to change the direction of investment. Furthermore, it led to maneuvers to expand investments and markets in Russia's partner countries.

CONCLUSION

The Ukrainian crisis, which erupted in February 2022, has had a significant impact on the global stage. It is imperative to delve into how this crisis has shaped worldwide Foreign Direct Investment (FDI) and Russian FDI flows. Studies have shown that the majority of sanctions imposed since 1990 have had adverse effects on FDI in both directions.

When a country imposes sanctions, it applies economic pressure on the targeted nation in hopes of swiftly resolving conflicts. However, these sanctions can result in short-term negative consequences for the economy of the affected country. For instance, during an energy embargo, the European Union drastically reduced its energy supply to specific countries, leading to an increase in supplies to uncertain destinations. This shift has prompted Western nations to seek self-reliance and reduce their reliance on exports.

Furthermore, trade embargoes have drawn investment from alternative partner countries and have allowed some Transnational Corporations (TNCs) to gain a less competitive advantage. This has reshaped the global economic landscape and highlights the importance of understanding the intricate relationship between crises, sanctions, and FDI flows.

Sanctions imposed by the US and EU countries have resulted in a decline in Russian economic growth. Consequently, Russian foreign direct investment (FDI) flows have been directly and indirectly affected. In the short term, Russian FDI has seen a decrease due to the current conditions. However, in the long term, the negative impacts are expected to be alleviated. It is crucial to consider the potential positive outcomes that may arise from the development of new sources and changes in the structure of Russian FDI flows.

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