Efficacy of Sanctions against Energy-Producing Countries

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ECONOMIC SANCTIONS HAVE BECOME THE TOOL OF CHOICE FOR AMERICAN FOREIGN POLICY. This is particularly true after recent painful experience with military interventions in Afghanistan and Iraq and because of the perceived success of past economic sanctions.

At a time of plentiful oil and gas supply and cyclical downturn in energy pricing, this especially applies to offending oil-producing countries, which became more vulnerable to sanctions, with seemingly little consequence to global energy markets. Sanctions against Iran over nuclear proliferation and against Russia for its aggression against Ukraine are the two most prominent current examples.

Iran was always dependent on oil revenue, which contributed more than 60 percent of government revenue and 80 percent of export earnings. Mismanagement of its economy made Iran more vulnerable to an oil embargo by the European Union and the United States, which also forced other buyers of Iranian oil to reduce their imports. As a result, Iranian oil exports were reduced by 1 million barrels per day (mmbd) with severe negative impact on the Iranian economy.

Assuming that Iran complies with the terms of the nuclear deal it reached with the five permanent members of the United Nations Security Council and the

European Union, it will be allowed to resume and increase oil exports in 2016, first from tanker storage of unsold oil and subsequently from increased production. Although Iran's official production target in 2016 is to reach pre-sanctions level above 4 mmbd, it will likely take a couple of years and investment to rejuvenate declining oilfields before this target can be met. Nevertheless, even a modest but steady increase in Iranian oil exports would prolong the current slump in oil prices while extending the desire of other major oil producing countries to protect their market share.

Longer term, Iran has more ambitious plans to increase its oil production and to exploit its enormous natural gas potential to become a net gas exporter. It has begun preliminary talks with international oil companies and shown a willingness to modify contract terms in order to attract massive investments. Previous Iranian governments chased away foreign oil and gas investors, including those from friendly countries, through harsh commercial terms and difficult operating conditions, even before international sanctions came into force. This made multilateral sanctions easier to apply when they came—an object lesson perhaps for the future. However, it will take at least five years before major contracts can be negotiated and for new investment to bear fruit before further increases in Iranian oil and gas production can have any impact on the global energy market.

Under Vladimir Putin's rule, Russia has become a petro-state in ways the Soviet Union never was. Oil and gas represent 50 percent of central government revenue and 70 percent of export earnings. An import-dependent Russian economy requires oil and gas income to prosper. The ruble has lost half of its value since the oil price slump and more severe Western economic sanctions were implemented in July 2014. An already-stagnant economy has fallen into deep recession and is unlikely to recover until 2017 unless oil prices spike and until major structural economic reforms are enacted, neither of which is likely to happen.

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The current Western economic sanctions were never designed to impact short to medium Russian oil and gas production. They were designed to affect longer-term prospects for production from frontier areas such as the Arctic offshore, unconventional oil (also known as shale oil or tight oil), and sales of high technology for such projects. Indeed Russian oil production remains at a post–Soviet peak and gas production is constrained more by weak demand domestically and in export markets. The ruble collapse lowered costs of Russian oil producers while their export revenue is still denominated in dollars. Russia's central government, which took the lion's share of oil revenue above $40 per barrel through the taxation system, suffered the brunt of the oil price decline, along with the inefficient general economy that the government subsidized. Western financial sanctions have a greater impact on Russian oil and gas companies, especially national champions Gazprom and Rosneft, by limiting their access to external markets to refinance their debt and to finance new investments.

As such, Western sanctions have done exactly what they were designed to do: impacting the Russian economy without negatively affecting oil and gas flows. Whether it will modify Russian behavior in Ukraine remains to be seen. It may take more time than we wish, which challenges the preservation of Western unity. Meanwhile, Russia may become more desperate in Ukraine and elsewhere to test that unity.

History should have taught us that economic sanctions alone are an imperfect tool. Sanctions against Saddam Hussein's Iraq lasted for more than a dozen years and did not change his policies very much until the United States invaded Iraq and toppled his regime. Larger countries like Russia and Iran have more policy options to defend their interests by dividing the international alliance against them without which unilateral U.S. sanctions would be ineffective. For example, Russia supplies one-third of Europe's oil and gas demand and European economies are more interlinked with Russia than the American economy. Iran is a major oil supplier to countries such as Turkey, India, China, Japan, and Korea, which remain interested to do business with

Iran. Both Russia and Iran can accuse Washington of forfeiting the interest of our closest allies and trading partners since America is less dependent on imported energy than they are.

Major energy-producing countries can form temporary alliances of convenience to evade sanctions, such as what Russia is currently attempting to do with China. Temporary actions can develop into more permanent conditions with significant geopolitical consequences. As a permanent member of the Security Council, Russia in particular can block U.N. action in other areas and use its political and military influence in situations such as the civil war in Syria and the fight against the Islamic State. Iran is a regional power in the energy-critical Persian Gulf and an increasingly fragmented Middle East, a position it can use for good or ill.

Much of the effectiveness of U.S. economic sanctions is derived from the dominance of American financial institutions and use of the dollar in international commerce, and the threat of secondary sanctions against violators of multilateral sanctions. This puts a premium on arriving at internationally agreed multilateral sanctions, which is more difficult against major energy-producing countries and involves a process that often leads to the lowest common denominator to the annoyance of U.S. policymakers. It also increases the incentive for major energy-producing countries under the threat of sanctions to create alternative international payment, insurance, and other financial systems that avoid Western institutions in cooperation with major energy-importing countries, such as China and India, which wish to chart their own independent course of foreign policy.

The fact that economic sanctions take a long time to become effective and are slow in achieving their policy objective of changing the behavior of offending countries often frustrates U.S. policymakers. The temptation then is for Washington to ratchet up sanctions unilaterally, if necessary. In the case of sanctions against major energy-producing countries, this can lead to the fracturing of the coalition enforcing sanctions and to a more determined adversary seeking to evade sanctions and threaten retaliation elsewhere.

Economic sanctions are not the silver bullet when used against major countries, especially those that produce a critical, fungible, and widely traded commodity. They should be used judiciously, along with other statecraft such as diplomacy and the threat of force. The objective should be to bring the offending country to the negotiation table for a more permanent solution. A case in point is the nuclear negotiations with Iran and the hoped-for resolution in 2016. An even more challenging case will be Russia and settlement of the crisis in Ukraine, triggered by its aggressive actions, which will likely be with us beyond 2016. These will not be the last time economic sanctions will be waged against oil-producing countries. No doubt their lessons will continue to be learned and relearned by all. □