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Economic Sanctions, International Trade and Foreign Direct Investment: Channels and Spillovers

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Abstract

Economic sanctions have become an important instrument of geopolitical policy, with potentially substantial consequences for international trade and foreign direct investment (FDI). This study qualitatively investigates the effects of economic sanctions on bilateral trade flows and cross-border investment, focusing on direct economic costs, trade diversion, and changes in international economic linkages. The analysis further considers whether sanctions are associated with changes in FDI inflows and whether third-country economies experience trade diversion as firms and governments adjust their international economic relationships.

Keywords: *Economic Sanctions, Bilateral Trade, Foreign Direct Investment, General Equilibrium Sanctions, Extraterritorial Sanctions.*

Introduction

Economic sanctions are used to restrict trade and other relationship with other countries at international level (Meyer et al., 2023). These restrictions include tariff and non-tariff barriers such as import and export quota, tariff rates, investment restrictions (Smeets, 2018) and such other restrictions on individuals, investments, companies (Cilizoglu and Early, 2021; Hufbauer, 2021) and technologies. Economic sanctions increased after World War II (Morgan et al., 2023). It is also treated as a policy tool (Felbermayr et al., 2025) to discourage goods from some countries. During current Era, European Union (EU), United Nations and China are the main initiators of these sanctions (Sokolova and Yakushev, 2023). Economic sanctions can be effective but it is dependent on several other factors and they have several impacts as well (Smeets, 2018) such as impact on international production, supply, cost of products specially technology and ultimate impact on the consumers in the sanctioning countries (Mihranyan and Vyshegorodtsev, 2025). Although the effectiveness and efficiency while imposing the sanctions are often underestimated and there is a lack of studies in this area, which further can be studied and can be understood as achievement of predetermined goals (Pala, 2021). Though literature has already proved that smart sanctions are used to solve several political problems but they do not provide better policy results when compared to the other trade sanctions (Drezner, 2011). Literature has also proved that in recent past several countries have imposed major sanctions in different geopolitical regions (Boulègue, 2022). In recent past four countries majorly faced sanctions i.e. Russia, Iran, Venezuela, and blockade-style pressure on Cuba. Following the US capture of Nicolás Maduro in early January, the literature from 2026 depicts a dramatic shift toward coercion in Venezuela, with widespread opposition from China, Russia, and Latin American nations as well as an emergency UN debate (Singh, 2026; Yusran, 2026). The US sanctions on Iran from 2006-2026 led to severe oil export collapse, currency depreciation and other economic consequences (Razzaque et al., 2026). Howevere, Russia

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remained one of the targets for the sanction by several countries including EU and US (Anikin, 2026; Cobanoglu and and Yıldız, 2026). Present study attempts to analyze the major sanctions imposed on these four countries by linking sanctions with foreign direct investment. It analyzes the literature available and also tries to establish the economic effect of the sanctions and their impact on trade, FDI, and other sectors.

Further, Section 2 discusses conceptual background of the area and section 3 presents literature review available, section 4 presents stylized facts and analyses related to the sanctions imposed on various countries. Section 5 presents conclusion, discussion followed by references.

Conceptual Background

Economic sanctions are defined as the measured, withdrawal or threat of withdrawal for trade and other financial relationships by nations (Yakoviyk and Novikov, 2024). During current era economic sancitons have emerged as an alternative to the military warfare (Teslya, 2024), which emerged during World War I (Rodionova, 2024). The Paris Peace Conference during 1919 mentions economic sanctions as formal instruments of collective security (Himes, 2025), however during wartime they were used to create shocks. After World War II, especially when some countries are willing to dominate the world (Teslya, 2024). Hence literature has not achieved any consensus over the issue of effectiveness of the sanctions and needs to be analysed for these countries.

Review of Literature

The past two decades have experienced a major shifts in the nature of sanctions, although in recent past most of the sanctions were imposed by United states (Cilizoglu and Early, 2021; Sokolova and Yakushev, 2023). Technology has played a significant role in changing the nature of sanctions and US and China trade war added new landscape to the sanctions related to the trade and ultimately political diplomacy (Hufbauer, 2021).

The literature on the impact of economic sanctions is inconclusive as it does not reach to the consensus of the outcomes. It is already evidenced that effectiveness of the policy instruments are not same with across countries (Mihranyan and Vyshegorodtsev, 2025; Pala, 2021). Sanctions generate costs for the entire countries involved sender as well as targeted countries, which gives a scope for the other countries around the world (Smeet, 2018).

- **Impacts of Sanctions in the Countries**

Sanctions leave adverse effects on the Targeted countries on the basis of trade, human grounds, GDP, inflation, mental health, political stability (Özdamar and Shahin, 2021). Economic sanctions also leave adverse impact on health, income equality (Aloosh and Aloosh, 2019), rule of law democracy, human and economic rights of the citizens and growth (Herbert,2024). They also negatively affect the institutional structure of the targeted nation and ultimately discourage other international investors (Meyer et al., 2023).

Although literature suggests that sufficient numbers of studies are not available that examines the impact of sanctions on the targeted and other associated countries. Since it is assumed that the sanctions are imposed without thorough metrics analysis of the effect (Felbermayr et al., 2021; Farzanegan, and Batmanghelidj, 2023; Mihranyan and Vyshegorodtsev, 2025). Figure 1 presents recent empirical studies on the economic impacts of the sanctions.

Table 1: Empirical Findings on the Economic Impacts of Sanctions

Author	Variables	Methodology	Findings
Gutmann et al., (2021)	Negative effects on GDP, consumption, investment, and trade	Event study with difference-in-differences	Macroeconomic effect
Afesorgbor (2019)	Imposed sanctions reduce trade; threats increase it via stockpiling	Gravity model, disaggregated data (1960–2009)	Threatened vs. Imposed Sanctions
Bělín and Hanousek (2020)	Broad import sanctions reduce trade more than narrow export sanctions	Natural experiment with bilateral trade data	Sanctions Design
Farzanegan and Batmanghelidj (2023)	Target economies adjust to new equilibria, decreasing political effectiveness over time	Literature survey and synthetic control method	Sanctions Adaptation

Source: Authors'

Stylized Facts

To present quantitatively the sanctions on Russia are shown in Table 2, where country-wise and sector-wise sanctions on Russia are shown after year 2022.

Table 2: Country-wise Sanctions on Russia since February 2022

Country	**Sanctions on Russia**
Australia	1571
Canada	3722
EU	2534
France	2463
Switzerland	3773
UK	2097
US	6441
Japan	1359
Sector-wise Sanctions on Russia since February 2022	
Sectors	**No of Sanctions**
Aircraft	105
Entity	9061
Individual	13611
Vessel	1183

Source: Compiled using https://www.castellum.ai/russia-sanctions-dashboard

As per the available studies effects of sanctions can be categorized in three sections; primary, general equilibrium and extraterritorial effect. These three types of impact presents the channels through which sanctions operate, which are explained below with the help of Figure 1, Figure 2 and Figure 3.

- **Primary Impact of Sanctions**

The primary effect is the direct effect on the targeted country through several channels such as export prohibition, assets freeze, and financial restrictions which ultimately has an impact on international trade (Hufbauer, 2021; Felbermayr et al., 2025) investment, assets, investment, payments, FDI (Yang et al., 2004), technology and leaves an adverse effect on the end consumer, higher cost, lower choices, and reduced transactions which ultimately leads to lower growth (Neuenkirch and Neumeier, 2015). Figure 1 conceptualized and explaines it;

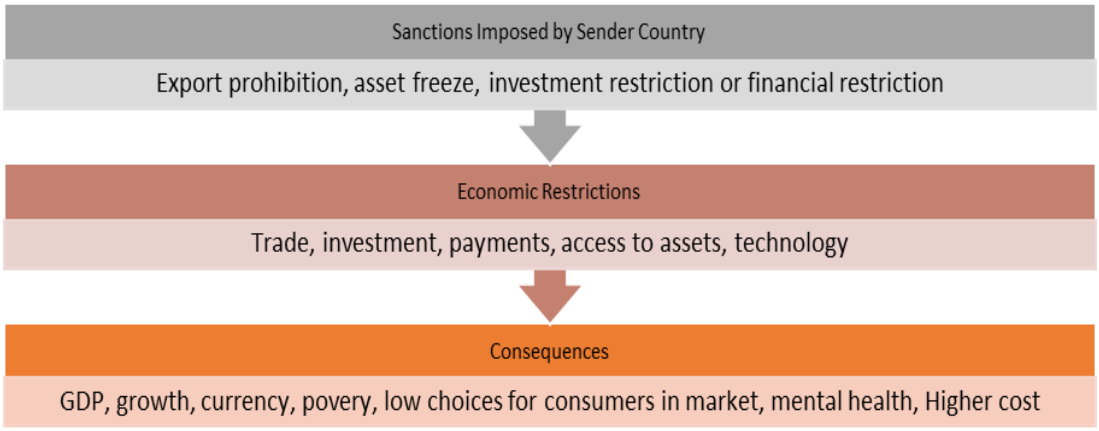


Figure 1: Primary Impact of Sanctions

Source: Authors' compilation

Specific sectors such as banking, tourism, energy, and agriculture also suffer. Notably, some effects linger even after sanctions are lifted, affecting economic development and trade flows. Additionally, the impact of sanctions is heterogeneous, varying by type (e.g., arms vs. financial sanctions), industry, and duration. Multilateral sanctions yield stronger effects compared to unilateral ones, highlighting significant variability in their consequences.

- **General Equilibrium Impact of Sanctions**

The general equilibrium effect of sanction measures the effectiveness of the sanction, after adjusting for markets, sectors, countries and agents. It measures the effect beyond direct effect of the sanctions. It helps in mitigating the direct impact of the sanctions by two ways; by restricting the target economy or by restricting the economic activity of the targeted country (Felbermayr et al., 2025). And sometimes GE effect leaves positive impact on the targeted country for instance Iran improved its agricultural sectors productions (up to 30 %) due to trade sanctions (Felbermayr et al., 2025).

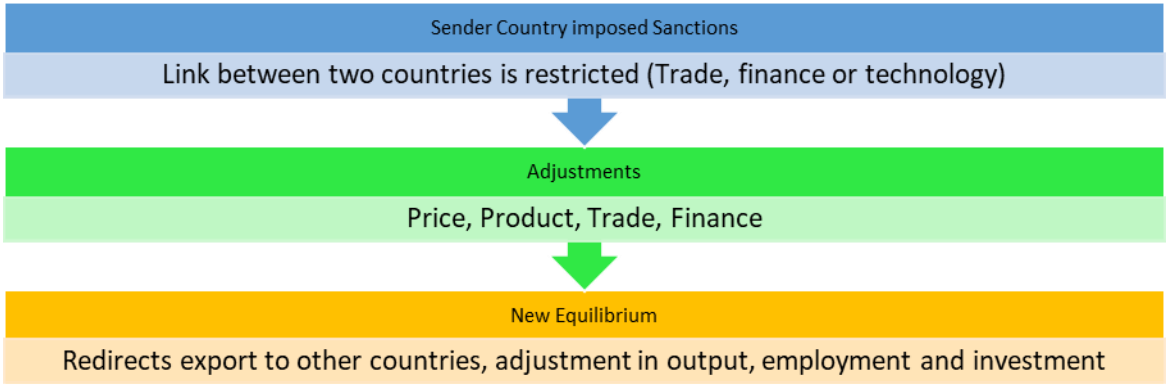


Figure 2: GE Effect of Sanctions

Source: Authors' compilation

In general equilibrium the country adjust its production, output, employment and moves towards trade diversion, where third countries enjoy the benefits of sanctions, which is proved by the sanctions on Russia. As a result of the sanctions imposed on Russia for its invasion of Ukraine, China and India were able to purchase cheaper oil from Russia, which is another way that the third nations profit from the GE repercussions (Felbermayr et al., 2025).

- **Extraterritorial Effects of Sanctions**

The impacts of sanctions on businesses, nations, or economic activity outside the borders of the sanctioning nation and outside of the specifically targeted bilateral relationship are referred to as the extraterritorial impact of sanctions (Moehr, 2019). This effect can further be divided into two types; economic extraterritorial effects and legal extraterritorial effects.

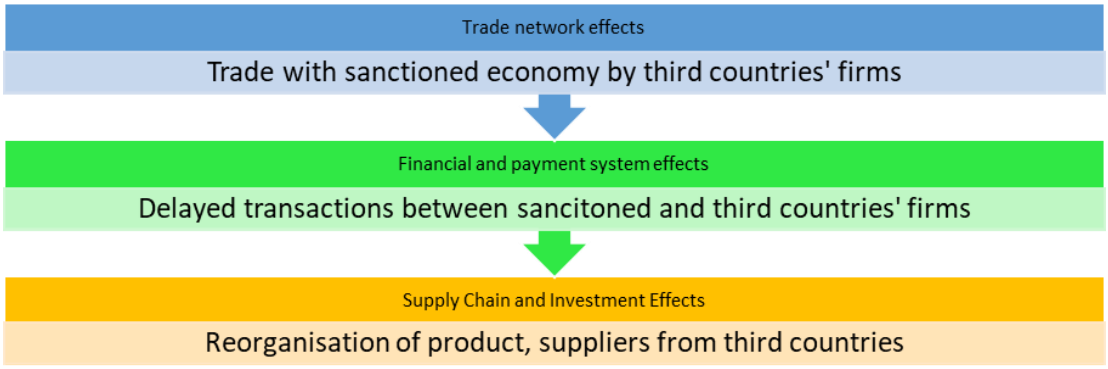


Figure 3: Extraterritorial Effect of Sanctions

Source: Authors' compilation

Hence these three concepts can be integrated and anlysed into a single structure; primary effect of sanctions are direct sanctions between sender and a targeted country which changes the bilateral trade between those countries, GE effect, finds reallocation of resources, changes prices and real income, which ultimately leaves an impact on trade, output and welfare. While extraterritorial effects leave an impact on the non-sanctioning countries and foreign firms by trade, investment and supply chain effect.

Conclusion and Discussion

In present study we tried to analyze the impact of economic sanctions on three aspects, direct (primary), and General Equilibrium and Extraterritorial effects. We used data to show sanctions on Russian economy and sectors. By going through the literature we establish that the impact of primary sanctions is long lasting but broader economic effect can mitigate these effects. Available literature also show that sanctions can harm targeted country but effectiveness of the sanctions is typically low. This may be attributed to insufficient costs imposed on targeted states and the ineffectiveness of sanctions in addressing activities closely related to the objectives. The success of sanctions also varies based on measurement methods and the context of foreign policy decisions. Our theory explains why penalties are applied and pinpoints the circumstances that affect their efficacy through their influence on resource-using activities. It implies that penalties might succeed even at the threat stage, before being imposed, and might not necessarily accomplish senders' goals. This method makes it easier to conduct additional research on the connections between sanctions and armed conflicts, such as those in the Middle East and Ukraine.

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