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Russia’s Economy under Sanctions: Early Impact and Long-Term Outlook

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Abstract

Four months after a coalition of Western states imposed unprecedented sanctions on Russia, the Russian economy seems to be holding up better than expected. The Central Bank has managed to stabilize the country’s financial system and Russian officials are trying to project optimism about the future. However, this optimism is likely to be short-lived. The sanctions’ effects are only just beginning to unfold: supply-chain problems are intensifying and demand is falling quickly. In the longer run, Russia’s economy will become more primitive as it partially decouples from international trade. To avoid social tensions, the government will intervene to support Russian businesses, leading to more protectionism and a larger state footprint in the economy.

Introduction

During his speech at the plenary discussion of the St. Petersburg International Economic Forum on June 17, Russian president Vladimir Putin claimed that “The dire forecasts for the prospects of the Russian economy […] have not materialized.” That month, the consensus forecasts published by the Russian Central Bank improved, predicting a slightly less devastating crisis than previously anticipated: a fall in GDP by 7.5 percent instead of 9.2 percent in 2022. Russian top officials have been busy showcasing even stronger optimism: Economy Minister Maxim Reshetnikov said he is expecting a contraction of 5–6 percent, while presidential advisor Maxim Oreshkin stated that the decline will be below 5 percent, only to be trumped by Vice Prime Minister Andrey Belousov, who is speaking of a 3–5 percent decline in GDP. Survey results from Levada appear to show recovering sentiment among the Russian population, too: the share of respondents stating that sanctions are creating problems for them personally fell from 29 percent in March to 16 percent in May.

Russia was unquestionably successful in stabilizing its financial system after a short period of panic that included some bank runs and acute liquidity shortages among banks. With the help of strict capital controls and a steep interest rate hike (from 9.5 percent to 20 percent), the Central Bank managed to control the ruble exchange rate and the inflation rate, two economic indicators that play a big role in ordinary Russians’ perceptions of the health of the economy. After spiking to 150 rubles/euro in mid-March 2022, the exchange rate was converging on 50 rubles/euro by June. The inflation rate raced to almost 18 percent in April 2022, but prices began to fall thereafter, with annual inflation retreating to 16.7 percent in June. Containing inflation and the strengthening of the ruble have helped to uphold an illusion of economic normality within Russia. At the same time, both developments hint at problems to come.

Before the introduction of capital controls, ruble fluctuations were indeed a good indicator of the optimism or pessimism of local and international investors regarding the future of the Russian economy. When sanctions risks were on the rise, as in August 2018, the ruble usually fell. Under the new rules, however, the meaning of the exchange rate has changed: It now simply reflects the balance of imports and exports. Due to Russia’s structural trade surplus, capital controls were bound to result in a strong ruble, even without the high energy prices and large export volumes in the first months of the war. To some degree, Russia’s struggle to import has also contributed to the appreciation of the ruble. However, already by May 2022, the strengthening of the ruble had turned from a success to a concern due to its negative effects on both exporters and budget revenue, sparking a debate among Russia’s economic policymakers about whether and how to effectively weaken the ruble.

Similar to the ruble, the inflation rate has partially lost its meaning after February 2022: While it represents the price changes of a certain basket of goods and services, it does not directly account for disappearing choices. Sanctions and the retreat of Western companies have made many consumption options simply unavailable. At least for better-off Russians, this has affected their living standard more than the rising prices. Furthermore, while inflation may be the result of a stronger ruble putting pressure on the prices of some imported goods, it is more likely to result from falling demand, an unequivocally bad sign for Russia’s economy in the coming months.

Optimism Will Be Short-Lived

Very early in the crisis, several car manufacturing plants came to a standstill due to a lack of parts and the retreat of foreign brands from Russia. The industry, which employs around 600,000 workers in Russia, plays the
role of the “canary in the coalmine” for Russia’s economy, as it has the most complex and internationalized supply chains. Even though the situation is not yet as acute for the rest of the economy, there is hardly any sector of Russia’s economy that is not struggling with a shortage of parts, machinery or services. The causes are usually problems in processing international payments and organizing logistics, as well as the unwillingness of foreign companies to do business with Russia, whether due to restrictions or to reputation concerns. Trade statistics are showing the severity of this issue, as Russia’s imports from sanctioning countries have collapsed by 50 percent or more in comparison to the previous year. Imports from China have also halved compared to their level in December 2021.

The effect of the sanctions on Russian industry is delayed because some producers still have a few months’ worth of Western supplies on their shelves, but the problems are adding up each month and will eventually be a serious constraint on output. Some sectors, especially in the natural resources industry, are squeezed in a sanctions sandwich, facing constraints on both technology and export markets. Oil production has shrunk by 10 percent as some Western importers shun Russian energy shipments. According to steel magnate Mordashov, steel production has declined by 25–30 percent due to sanctions, while lumber production is down 80 percent. Although Russia started 2022 with much higher industrial production than in 2021 (+8.6 percent), the positive dynamic had already reversed by April: According to Rosstat, output was 1.6 percent below the previous year, with the auto sector contracting by a whopping 61.5 percent.

Similar to the supply chain issues, the effect of sanctions on unemployment is delayed, as Russian businesses avoid laying off workers until it becomes inevitable. Instead, many companies have introduced part-time work and/or partial shutdowns of production with minimal pay. Many foreign companies—which, according to some estimates, directly and indirectly employ 6–8 million Russians—have continued to pay workers even after shutting down their businesses. This has kept the official unemployment rate at a historic low of 4 percent. However, according to the popular Russian career portal HeadHunter, the number of job vacancies is down by 21 percent in comparison to last year, with job postings in some fields (especially in insurance, banking, and finance) plummeting by 89 percent. Despite the departure of many highly skilled specialists and guest workers from Russia, the unemployment rate is expected to rise to over 7 percent by the end of the year, with industrial regions like Kurgan, Ulyanovsk, and Kaluga most affected by layoffs.

While the effect of the sanctions on different sectors of the Russian economy was initially very uneven, the decline in production and rising unemployment (or underpayment) will in the coming months lead to broad-based demand contraction, pulling down other businesses that were initially not directly affected. These second-round effects are likely to be the dominant reason for the current decline in prices. Retail turnover, which was 5.7 percent higher year-on-year in February, was already 9.7 percent below the previous year by April, according to Rosstat. Credit card data for June, published in an analysis by Sberbank, confirm this steep decline. The situation in industry looks similar: According to surveys carried out by Rosstat, businesses are disappointed by the demand in June 2022 and optimism has fallen to the lowest level since the coronavirus lockdowns of April 2020.

A Look Ahead
It is impossible to predict at what point Russia’s economic decline will bottom out quantitatively, as key variables such as the future dynamic of imports and possible cascading effects caused by a lack of critical parts are uncertain. However, some qualitative trends that will shape the country’s longer-term development are already visible.

Russia’s future development critically depends on a number of key assumptions. Here, it is assumed that neither will sanctions be lifted nor will the political regime in Russia face an immediate collapse. Under these conditions, Russia’s economic crisis under continuous sanctions will be “L”-shaped, meaning that it will not result in a quick bounce-back like the previous crises in 1998, 2009, 2015, and 2020. Instead, Russia’s economy will permanently shift onto a less internationally connected and less technologically sophisticated development trajectory. This will not necessarily result in high unemployment, as modern machinery and investment are becoming scarce and will to some degree be replaced by labor. However, labor productivity will be much lower, leading to a significant decline in average real incomes.

The government’s response is likely to consist of well-known policy reflexes. The automobile industry is a case in point: The government is already trying to artificially create demand for technologically inferior cars “Made in Russia” through state procurement, on the one hand, and protectionist measures that keep international competition out, on the other hand. Stricter protectionism is effectively a tax on the Russian consumer, as it results in higher inflation and a further decline in real incomes. This effect was particularly pronounced after Russia’s “countersanctions” on Western agricultural goods following the annexation of Crimea, which led to high food inflation in 2014/2015. As the crisis deepens, the Russian state will also have to subsidize or take over strug-
gling businesses to keep their workers employed and avoid social tensions, particularly in industrial regions and Russia’s “monotowns.” Similar to the aftermath of the 2009 financial crisis, this means that the state’s footprint in the economy is set to increase. Nationalization of the most affected sectors has already begun where foreign investors are withdrawing: Renault’s 67.7 percent share in car manufacturer Avtovaz, for instance, has been taken over by the state-owned institute NAMI.

As a consequence of falling incomes and a larger state role in a less productive economy, the distribution of energy rents will play an even larger role in Russia’s political economy. A larger share of Russia’s budget will consist of subsidies and social policy expenditure. Although oil extraction is expected to decline by up to 30 percent as a result of the combined effect of technology and energy embargoes, the relative significance of oil and other commodity exports for the state budget has been growing in recent months. In contrast, Gazprom will no longer be able to cross-subsidize Russian businesses and households with cheap energy in the coming years after losing its key high-price export market: the EU. Instead, the gas behemoth is likely to become a liability for the Russian budget.

Finally, Russia’s economy will become less transparent and the informal sector will likely grow. Access to statistics about trade, production, and budgetary spending has already been curtailed, ostensibly to make sanctioning Russia harder, but more likely to hide negative developments from the public eye. Public scrutiny about the distribution of rents by the Russian state will become even harder, creating fertile ground for embezzlement and misappropriation of funds in the coming years. Meanwhile, sanctions and the retreat of Western companies are creating strong economic incentives for parallel import and shuttle trading. Sanctions evasion could even become a significant business model in the Russian economy. Shuttle trading will mainly be a boost to Russia’s informal economy. Because transit countries are trying to avoid the risks of secondary sanctions, sanction evaders will often operate in a legal grey zone, making it likely that organized crime will try to get its share of the sanctions arbitrage business as well.

About the Author
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Why Russia Is Lacking an Economic Strategy for the Future
By Michael Rochlitz (University of Bremen)
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Abstract
Even before the economic crisis caused by Russia’s full-scale attack against Ukraine and the ensuing sanctions, the Russian economy was plagued by a number of growing problems. As a result, Russia’s economy has hardly grown for almost a decade, with an average annual growth rate of just 0.5% between 2013 and 2021. However, the Russian government does not have a strategy for addressing the fundamental economic challenges that are looming just over the horizon. There also seem to be no public debates about these challenges, whether in the policy circles around the government or among the wider public.

Introduction
Even before the economic crisis caused by Russia’s full-scale attack against Ukraine and the ensuing sanctions, the Russian economy was plagued by a number of growing problems. The attempt to reform the education system had produced mixed results, with many of Russia’s regional schools and universities failing to equip their students with the necessary skills for a modern economy. In many parts of the country, the transport infrastructure, energy grid, and healthcare system remain outdated and are slowly decaying. After some small demographic policy successes in the mid-2010s, Russia’s population is