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Perspectives

The authoritarian state was in 2020 in some aspects more efficient than the Western democracies in combating the Covid-19 pandemic. However, taking into consideration that the pandemic and its outcomes might plague economies and societies longer than expected, autocratic tendencies can find even more support in public opinion. In addition, the growing role of the state and semi-state owned monopolies, and now also of direct state interventions, into the process of price formation and competition on different markets is a sign of a new stage in the backslide transition in Russia: growth expectations being too closely connected with state investment activity and public-private partnerships will be dangerous for the Russian economy in the long run.

About the Author

Prof. Dr. Alexander Chepurenko is Professor of Economic Sociology at HSE University Moscow. In his research, he focuses on entrepreneurship and small business development in Russia and other former Socialist economies and related issues. He was co-editor of 'Entrepreneurship in Transition Economies' (Springer 2017) and has authored many papers on entrepreneurship, small business, SME policy, etc. in international journals.

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»Fortress Russia« Effective in the Corona and Sanctions Environment Short-Term, More Stagnation and Sanctions Ahead

By Gunter Deuber (Raiffeisen Bank International, Vienna)

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Russia has come fairly well through 2020 and 2021 in the real economy. With a decline of 3%, output slumped less than the global economy and only about half as much as in Western Europe. This remarkable 2020 performance was a result of Russia seeking short-term and opportunistic cooperation with OPEC. Domestic oil production was curtailed under the OPEC+ agreement. Oil output dropped by 8.5% year-on-year in 2020, lowering GDP growth by 1.0 pp.

Satisfactory Economic Performance Due to Structural and Cyclical Factors

The satisfactory performance has to do with economic structures, policy responses and a better-than-expected global environment. The low complexity of the Russian economy with a low share of services, which are sensitive to Covid-19 restrictions, has prevented a deeper collapse. Moreover, proactive fiscal countermeasures have been taken, with a federal budget deficit of 4.5% of GDP. For the first time, the government reacted to a crisis by upping expenditures and temporarily blocking the budget rule. Rapidly recovering commodities supported exports, while imports dropped sharply. Lower oil and gas exports were partially offset by growing gold and wheat shipments (exports: –5.1% yoy) while imports declined by 13.7% yoy. Therefore, net exports added +1.4 pp to GDP dynamics.

Some fiscal support will remain—at least in 2021. The National Wealth Fund (NWF) will not be replenished due to temporary changes to the fiscal rule; a replenishment could restart in 2022. Moreover, the NWF's liquid assets are to be invested already in 2021 as their sum exceeds the 7%-of-GDP threshold, presumably in infrastructure projects. Therefore, policy-induced growth impulses should be set in comparison to the pre-pandemic stagnation. In the context of the 2021 election calendar, increases in social spending and one-off payments were announced during the recent annual state of the nation address to the Federal Assembly. However, Russia's Minister of Finance stressed immediately that the support measures will not require additional debt issuance and financing. However, the speech lacked major announcements in the direction of a far-reaching long-term stimulus package or sweeping reforms. For 2021 a post-pandemic recovery seems to be on track, allowing for a GDP growth of 2–3%. The Covid situation should allow for a decent economic performance in early 2021. Some very upbeat forecasters even project growth rates in the neighbourhood of 5% in 2021/2022, a scenario that looks less plausible given the projected rise in imports as well as chronic structural weaknesses and bottlenecks. Beyond 2021, economic growth is likely to settle closer to potential output growth around 1.5%.

Sanction Hit Avoided, Short-Term "Sanction Bubble" on Markets

The long-awaited tightening of international sanctions against Russia in recent weeks, especially US financial sanctions, has been well coped with. Market effects remained manageable, which has to do with the "Fortress Russia" strategy pursued since 2014. Russia has been preparing for a tightening of sanctions in many dimensions. Foreign debts were repaid, foreign exchange reserves have continued to rise and exceed foreign debts in absolute terms. The positions of foreign banks vis-à-vis Russia have also been stagnating for years. And if the state did borrow money on international markets, it was in euros and not in dollars. All in all, Russia has become less dependent on the international financial market and, to some extent, also on the US dollar and international payment structures. Moreover, the Russian banking sector is in a solid shape following the restructuring in recent years. Government bonds account for only 7% of total assets, compared to 15–20% in other markets. Therefore, local banks can well absorb the partially sanctioned sovereign issuance. In early 2021 there had been the possibility that too much of the market would bet on negative effects of sanctions, with the RUB trading 10–15% below the level that would be justified by fundamentals. Given this "sanction bubble," markets recovered somewhat following the April sanction round.

There have certainly been some economic policy successes. However, this should not distract from the challenging medium-term outlook. Real incomes have been stagnating or falling since 2014, even if this could turn around marginally in 2021. But there are also risks to this scenario. Currently we see a significant rise in (food) inflation. Now the central bank has to again take countermeasures to limit inflationary pressure and prevent the RUB from depreciating too much. The latter is also partly a component of the "Fortress Russia" strategy, which in sum does not represent a growth-friendly setup. This is especially true as monetary policy is likely to remain fairly tight in 2021 and 2022. Moreover, income declines have been broad-based and do not only affect the (poorer) rural population. The "Fortress Russia" strategy does not necessarily generate confidence among foreign economic actors. Rather, a stagnation in foreign involvement in the Russian economy is discernible, while there is an inward tilt in Russian supply chains.

Sanctions Outlook: Here to Stay, More to Come

The latest sanctions tightening by the US was well telegraphed. Most importantly for markets, the measures prohibit primary market purchases of RUB-denominated government bonds by US financial institutions. Previously, it had been sanctioned (since 2019) for US banks to buy Russia's foreign currency government bonds on primary markets. The complete sanctioning of Russian government debt is certainly a strong political signal. However, in terms of practical relevance, the impact is limited. Firstly, local state-owned banks have sufficient capacity to absorb the government bond issuance. Secondly, as long as such securities can be traded by US banks on secondary markets, the sanction impact is limited. Moreover, sanction measures in the government bond area are limited to US financial institutions, which limits the effect on US (non-bank) investors, non-US banks and non-US investors. So far, no extra-territoriality is being sought here. Despite harsh diplomatic reactions, the Russian central bank has taken a clear stand. The governor clearly addressed the small size of the impact of the tightening of sanctions on the real economy and financial markets.

So far, the US has shied away from far-reaching measures, such as a ban on secondary market trading or the exclusion of Russian entities from the international SWIFT payment system or US dollar payments. However, the risk of an expansion of sovereign debt sanctions has increased. Even the inclusion of primary market sanctions as part of the latest sanctions package was somewhat surprising but was justified by the urgency of sending a clear signal after the recent round of geopolitical escalation (sparked by Russia's large-scale manoeuvres on its border with Ukraine).

Even if the US sanctions have been moderate so far, a further and notable tightening along the lines of the options sketched previously cannot be ruled out. From a US perspective, the current measured sanctions approach, combined with efforts to remain in dialogue, should prevent an escalation. However, it does not look like this approach is well understood in Russia. Moreover, we see significant political pressure in the US for more sanctioning. Recent moves are seen just as a "first step" in the right direction; some observers clearly state that sanctions were apparently too light. It should also not be forgotten that sanctions against Russia on international markets driven by the US can be seen as an (indirect) policy signal towards China.

Overall, the risk of further sanctions remains high, and at the least there is no prospect of sanctions being eased. We are currently living in the seventh year of comprehensive Western financial sanctions against Russia, with US tightening especially in 2019 and 2021. The empirics of "successful" Western sanctions regimes, i.e. those in which a change in the behaviour of the sanctioned party was recognisable at some point, point to an ideal sanction regime duration of seven to ten years. Otherwise, sanctions tend to last much longer, sometimes even for decades. In the case of Russia, we can expect Western sanctions to last at least well into the 2020s, or possibly the 2030s. This scenario implies that there are more risks of ad-hoc and moderate escalation than possibilities for de-escalation. Therefore, the "Fortress Russia" strategy is likely to be continued, despite it being unconducive to growth and prosperity. Moreover, a "sanctions paradox" seems to be at work in Russia: the government, military and security apparatus are often strengthened in such a setting, as these circles can withstand sanctions even better than private companies.

We see a partly stable equilibrium in US–Russian relations ahead. Currently, we see an explicit commitment to arms control talks—the Kremlin remains open to cooperation in this field. Here the Kremlin has achieved what it wants: the US is talking to Russia at eye level. As long as Russia plays its geopolitical cards well and rightly assesses its macrofinancial way of manoeuvre—as it usually does—we do not expect the US to go for crushing sanctions. For all the rest, Russia is always well prepared. Our baseline view for 2021 and 2022 is that we do not see market-destroying US/Western sanctions as imminent. But well-dosed geopolitical provocations or surprises as well as tough measures to contain the opposition are always possible, and thus further face-saving but rather cosmetic Western sanctions.

About the Author
Gunter Deuber is Chief Economist and Head of Research at Raiffeisen Bank International in Vienna, one of the largest foreign banks in Russia. In 2019, he participated in the US Department of State's International Visitor Leadership Program (IVLP).

Sanctions Hurt Russian Economy

By Iikka Korhonen (Bank of Finland Institute for Emerging Economies, Helsinki)

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Abstract

After Russia's unlawful annexation of Crimea and undermining of Ukraine's territorial integrity as well as sovereignty, the European Union, the United States, Canada and many other powers placed various sanctions on Russian individuals and organizations starting in 2014. Multiple types of sanctions are still in place, but arguably those related to finance have to this point had the sharpest bite. In response, Russia has placed sanctions on food imports from countries sanctioning it. Even though sanctions regimes continue to evolve, researchers now have enough data to assess the economic effects thereof. It seems that Russia's economic growth has been slower due to the sanctions, and Russian banks have become much less integrated with the global capital markets.

Sanctioning Large Countries Unusual

It should be noted that there are no real precedents for sanctioning a country like Russia. Most other countries facing international sanctions are much smaller and less integrated into the global economy—e.g. North Korea and Syria. Historical examples, such as the Soviet Union and South Africa, were also much less integrated with the global economy than present-day Russia. However, it should be noted that Western sanctions have refrained from hindering Russia's energy exports, the sector in which Russia is most integrated with the global economy. Instead, sanctions have targeted either very specific product categories related to oil and gas exploration, or finance.

As it is now more than seven years since the first sanctions were levied, a number of econometric studies have looked at the overall macroeconomic effect of the sanctions. The International Monetary Fund (2019) concluded that sanctions shaved 0.2 percentage points off of Russia's GDP growth every year between 2014 and 2018. As Russia's GDP growth between 2012 and 2019 averaged approximately 1%, this is significant. However, the study also notes that changes in the price of oil have a much larger effect on Russia's GDP than sanctions.

Some other recent papers examining the macroeconomic effects of sanctions include Barsegyan (2019) as well as Pestova and Mamonov (2019). Using the synthetic control method, Barsegyan finds that, on average, Russia's per capita GDP was 1.5% lower between 2014 and 2017 than it would have been without sanctions. Pestova and Mamonov find that Russia's GDP was 1.2% lower at the end of 2015 because of sanctions. Korhonen (2019) offers a review of several studies on the topic.

Trade Sanctions

Trade sanctions from the EU, US, etc. have targeted only very narrow categories of goods. Bělin and Hanousek (2021) find that the Western trade sanctions had only a miniscule effect on the value of exports to Russia. It is, of course, possible that in the long-run e.g. reduced access to high-tech oil and gas exploration equipment could curtail activities of Russian energy companies. However, Russia's own counter-sanctions targeting foodstuffs have had a much larger effect on bilateral trade, perhaps up to eight times as large.

It is clear that Russia's sanctions affected different EU countries differently—those with more food exports to Russia were hit harder. On the other hand, alcohol exports to Russia were not affected. More generally, companies in countries with more extensive ties to Russia seem to be more concerned about sanctions, as evidenced by their annual reports (Davydov et al., 2021).

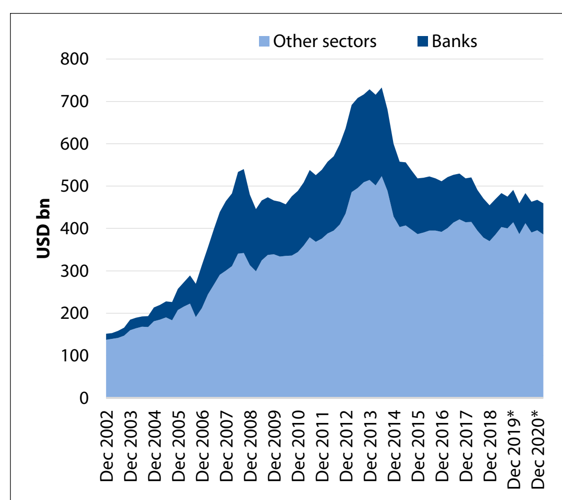
Volchkova et al. (2018) conclude that counter-sanctions have clearly reduced the welfare level of the average Russian household by raising prices of many goods. On average, every Russian has had to decrease consumption of banned items by 2,000 rubles per year.

Financial Sanctions

It can be argued that the most important sanctions tool so far has been prohibiting long-term financing for many major state-owned companies. Companies in the banking sector included Sberbank, VTB, Gazprombank, Rosselkhozbank (Russian Agricultural Bank) and VEB (Russia's state-owned development finance institution). For Sberbank and VTB, which together control more than 60% of the Russian banking market, this was clearly a significant step towards isolating a part of the Russian economy from global financial markets. Furthermore, similar financial sanctions were introduced against companies in the energy sector, namely oil giant Rosneft, oil pipeline company Transneft, and oil exploration and refining firm Gazpromneft.

The effect of this isolation can be seen in Russia's foreign debt. From the end of 2013 to Q1/2021, Russia's total foreign debt has decreased by 37%, and Russian banks' foreign debt by 66%. During the past two years the level of foreign debt has stabilized at a new, clearly lower level. It is noteworthy that no Chinese or other non-Western banks have stepped in to replace Western banks in crediting Russian entities.

Figure 1: Russia's Foreign Debt Q4/2002-Q1/2021, USD bn.



** estimate*

Source: Bank of Russia

It is clear that reduced access to external finance is damaging to Russian companies' future growth, their stock market valuation, etc. Ahn and Ludema (2020) show that targeted companies performed poorly relative to other companies with similar characteristics. For example, their operating revenue fell by one-quarter and their total assets by approximately one-half in comparison to the control group.

In Conclusion

Economic relations between Russia and Western countries are now weaker and thinner than they would be without sanctions. Moreover, several new types of sanctions—related to use of chemical weapons and human rights violations—have been introduced by both the EU and the US. Based on the current political trajectory, it is hard to be optimistic about speedy removal of any sanctions. Economic effects of sanctions continue to accumulate, both in the West and (especially) in Russia.

Please see overleaf for information about the author and references.

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Dr. Iikka Korhonen is the Head of Bank of Finland Institute for Emerging Economies (BOFIT), a unit within the Finnish central bank specializing in analysis of large emerging markets, especially (but not exclusively) Russia and China. His research interests include monetary policy and exchange rates in emerging markets, business cycles, and effects of economic sanctions.

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The Impact of the Covid-19 Pandemic on the Real Sector of the Russian Economy

By Yuri Simachev & Andrei Yakovlev (HSE University, Moscow)

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The 2020 coronavirus pandemic caused the deepest recession in the global economy since the Great Depression of 1929–33. However, the economic crisis generated by the pandemic had a number of serious differences in comparison to previous crises. Sanitary measures introduced by national governments to prevent the spread of infection have artificially limited supply in the economy and, above all, in the B2C segment serving end consumers. The service industries and their dominant small firms were the main victims. At the same time, the problems faced by many companies were not related to their competitiveness. Another specific feature of the current crisis is its focused impact and the presence of "aftershocks". This has led to high uncertainty in supply chains and disruptions in global value chains. All of this has created new challenges for economic policy.

As part of a joint project between the National Research University—Higher School of Economics (HSE) and the Russian Union of Industrialists and Entrepreneurs, implemented in Autumn 2020 to Spring 2021, we tried to assess the consequences of the crisis caused by the Covid-19 pandemic for the Russian economy. In our analysis, we relied on Russian and international statistics and industry reports, and also conducted over 40 interviews with heads of enterprises and business associations in six large industries: retail, IT, tourism, pharmaceuticals, chemical industry, and automotive.

Our analysis leads to the following conclusions:

- Contrary to the very sceptical forecasts and expectations of Spring 2020, in general, in comparison with the EU countries, the crisis led to a noticeably smaller recession in the Russian economy: the decline in Russian GDP in 2020 was 3.1% against 4.9% in Germany and 8.1% in France. This result can be explained by the structure of the Russian economy, it being far less reliant on the service sector and small business, the areas most affected by sanitary restrictions during the pandemic. The lesser severity of the restrictive measures applied by the Russian government also played a role. At the same time, our interviews showed that one of the reasons for the "soft landing" was the greater resilience of Russian firms associated with their preparedness