Explaining the Limited Impact of Sanctions on Russia

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EXPLAINING THE LIMITED IMPACT OF SANCTIONS ON RUSSIA

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Background

Upon the commencement of Russia's military intervention in Ukraine in February 2022, a collective response was swiftly initiated by the United States, the European Union, G7 nations, and their allies (Martin, 2023). This materialised in the form of an unparalleled assemblage of economic, financial, diplomatic, and supplementary sanctions, which have been undergoing successive modifications and additions throughout the ensuing months (Eisen et al, 2023).

Initially, Western analysts forecast dire repercussions for Russia, with some predicting a double-digit decline in gross domestic product (GDP). However, actual projections have been significantly revised downward (see Table 1) with the International Monetary Fund (IMF) and the Russian Federal State Statistics Service (Rosstat) now agreeing on a mere 2.1% contraction for 2022.[2] While this would still represent by far the deepest recession in the country since 2009 during the global crisis, it pales in comparison to the economic shock and awe many expected at the start of the conflict.

Argument

Indicators suggest that the effects on the Russian economy have been less severe than anticipated and the structure has proven more robust than all initial forecasts predicted. Early in the conflict, many experts envisaged a 'lost decade', characterised by stagnation and decline (Armstrong, 2022). Pundits and world leaders believed that, in combination, the impact on the country would relegate it to an global pariah, ensure losses in the billions and perhaps even lead to a wholesale collapse of its financial system.

It is nevertheless doubtful whether this prediction remains consistent with the data; the actual outcome has deviated from expectations. In spite of becoming the world's

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[2] Compare this to Ukraine's 24% GDP dip in 2022. Britain's outlook has growth projected at a modest 0.4 % in 2023 and 1 % in 2024 (IMF 2023). The Russian government's pre-invasion forecast had been for 3% GDP growth in 2022.

most sanctioned nation ever (Schlåðe, 2022), it has managed to avoid a significant downturn. But the Kremlin hasn't just played a good game of economic defence. Its invasion of Ukraine destabilised the global oil market, raising prices, which provided it with a steady source of funds. (Lau, 2022)

In this article, we delve into the factors that have contributed to the resilience of the Russian economy and attempt to analyse the medium-term outlook

Context

Preparations
Moscow had begun preparing years ago to endure external financial pressure by shoring up its currency reserves and befriending China (Dabrowski, 2023). The government had also devised prudent fiscal and monetary plans to insulate the economy and mitigate the effects of expected Western responses.

Fiscal Policies and the Role of the Central Bank
One of the key factors that have contributed to Russia's stamina is the implementation of conservative fiscal policies by the central bank (CBR). The bank raised interest rates to 20% in the immediate aftermath of the invasion to curb inflation and support the rouble, before gradually lowering rates over the course of 2022 (Abramov, 2023) as price pressures eased and the currency stabilised (Floudas, 2014)

Government Expenditure Control
Government spending restraint has been another key dimension towards maintaining fiscal discipline amidst the circumstances (Dubinin, 2022). Continued austerity measures would help keep debt levels under check but they also pose risk of sluggish growth if public investments are curtailed drastically affecting areas such as infrastructure development or social welfare etc., potentially leading to socio-economic stress points within the country. Therefore striking the right balance between controlling expenditures without hampering key investment areas would be critical for sustainable medium term outlook.

Oil Price Sensitivity
Russia's fiscal stability largely hinges upon international oil and gas prices due to its heavy reliance on hydrocarbon exports for revenue generation. The government has set a benchmark price of $45/barrel for balancing its budget - *any* increase beyond this level will drive surpluses whereas a price drop shall lead to deficits. As these crude oil prices have steadily remained above the internal benchmark, it could anticipate continued fiscal surplus aiding further against external shocks.

Rouble Exchange Rate
Another aspect that has surprised observers has been the performance of the rouble. Despite initial fears of a sharp depreciation, the rouble has remained relatively stable (averaging -10% from its pre-war level against the dollar) thanks in part to the CBR interventions and conservative monetary policy (Bank of Russia, 2023). The firm

response, as well as restrictions on citizens exchanging roubles for foreign currencies, a substantial foreign reserves cushion and the decline in imports prevented the currency from collapsing despite reduced foreign investment and trade. (Eichengreen et al, 2023)

Stock Market

The stock market has shown a surprising level of resistance in the wake of the conflict. The benchmark MOEX index saw fluctuations but has not experienced significantly long-lasting declines, a testament to the underlying strength of the economy and the confidence of investors. The stock market is dominated by energy sector companies tends to reflect global commodities', particularly hydrocarbons, pricing. Hence a similar outlook as mentioned earlier regarding crude oil applies here too i.e., relatively stronger performance is expected if crude maintains an upward trajectory.

Some Economic Sectors

Whilst the war has led to disruptions in the energy sector, it has not resulted in a collapse of the industry. Russia has managed to maintain a steady flow of oil and gas exports, which helped cushion the blow of the downturn. Additionally, the agricultural sector has been showing promising signs of growth, with increased output in recent years (Zhang, 2023). This has partially offset the losses in other industries, such as manufacturing and construction, which have been hit harder by the crisis.

Inflation & Spending

While shoppers have faced higher inflation, currently around 6% annually (Table 1), consumer spending is steady. Programmes to cap price increases on essential goods and services have provided some relief. Unemployment has ticked up slightly but remains around historical lows below 4%. Wage growth has slowed but continues at a rate of over 5% per year in real terms. Retail sales were up over 5% in 2022, suggesting consumer confidence and spending power persists intact.

Political Economy

The country has been able to find alternative markets for its goods and services, particularly in Asia. It has also focused on developing domestic industries, reducing its reliance on imports and promoting self-sufficiency (Dąbrowski & Avdasheva, 2023). These efforts have helped to mitigate the impact of sanctions and maintain a degree of stability.

De-dollarisation of the system

The government implemented a series of strategic measures to alleviate the ramification of its disconnection from the foreign-dominated financial sector. Prior to the commencement of the conflict, CBR had already set its sights on diminishing the nation's reliance on Western currencies, with a particular emphasis on reducing dependence on the US dollar. In addition to the increasing utilisation of the yuan for payments, the structure of the National Wealth Fund's currency component was revised at the end of 2022, doubling the share in the Chinese currency to 60 % (Shamsfakhr, 2023).

Discussion

As surveyed by Simola (2023), published literature on the subject suggests that the overall effects of sanctions have been diluted by various factors. Russia is a large entity with an autocratic political regime that is more equipped to cope with imposed measures, at least over the medium term, whilst some key measures entered into force after a transition period. Moreover, the Kremlin has been able to mitigate the effects by diverting some of its export trade to new markets as most emerging economies have not joined the sanctioning coalition.

The purpose of sanctions has been to deprive Moscow of its ability to fund the invasion; nevertheless, its ability to sustain the campaign will probably endure unchanged in the foreseeable future. Instead of reducing war spending, it is apt to redirect resources from the civilian sector toward the defence industry. The war in Ukraine constitutes a highest geopolitical priority for Russia and is perceived as an existential matter (Mearsheimer, 2023). Even if revenues were to decrease, military expenditure would continue to rise through forced reallocation of resources, driving living standards to decline. It is moreover arguable that resentment with falling living standards would not *ipso facto* lead to a coup, uprising, or revolution, in view of the regime's strength and broad base of approval. "The idea that it's possible to defeat Russia economically is a dead-end, as it has all the basic resources inside the country – food, fuel, and ammunition" (Sukhov 2023).

The imposition of sanctions has engendered an increase in domestic backing for the state subjected to such punitive measures, including the president and his affiliated political party. Whilst the enduring ramifications remain uncertain, existing research suggests that, in the medium term, sanctions serve to fortify the position of the targeted government (Gold, 2023). Within this context, the utilisation of mercantile warfare aligns harmoniously with the Kremlin's overarching narrative, which portrays an antagonistic 'West' encroaching upon the cherished Russian *Weltanschauung*.

Export bans imposed by Western parties have concentrated on dual-use commodities, e.g. semiconductors, industrial machinery and automotive/aviation components, the rationale being that substituting these goods domestically would necessitate substantial modifications and years of concerted effort (Morgan et al, 2023). In contrast, although there was a massive decline in G7 exports in 2022, this was accompanied by a significant increase in EU/UK exports to ex-USSR countries such as Armenia, Kazakhstan, and Kyrgyzstan (Zolobova et al, 2023). These patterns align with the hypothesis this trade is rerouted towards Russia, and are far more pronounced for product groups subject to restrictions and for items equivalent to sanctioned ones (Chupilkin 2023). Intriguingly, the establishment of new supply routes required a relatively short period of approximately 2-4 months.

As regards Iran in particular, in addition to attack drones and other arms purveyed to the Red Army, it obtains weaponry in the free-for-all of Iraq -plus commercial equipment from other sources- and ships it across the Caspian Sea to Russian ports. There is even discussion between Moscow and Tehran of building a sanction-busting rail line around the Caspian that would allow access to products from India. (Karnitschnig, 2022). After decades of embargo, Iran possesses a stellar pedigree in subverting commerce controls.

Deductions

- ♦ The Russian government has kept expenditure on a tight leash, ensuring that budget deficits remain within manageable levels. The central bank has also played a pivotal role in stabilising the economy by maintaining a cautious approach to monetary policy (Gaur, 2023). These measures have enabled it to weather the effects of war, preventing the system from spiralling into a deep recession.

- ♦ If Moscow can maintain its current policy stance and continue to develop its domestic industries, it may be able to defy forecasts and achieve a reasonably stable and sustainable trajectory. Ultimately, the fate of her economy will be determined by a complex interplay of domestic and international factors (Syropoulos & Yotov, 2023). As the situation evolves, it will be crucial for policymakers and authorities alike to monitor these developments closely and adapt their strategies accordingly.

- ♦ Russia still faces obstacles to sustainable growth in the years ahead (Rácz, 2023). Conservative fiscal policies, a stable rouble, and a resistant stock market have all helped stabilise markets and limit recession risks for now, but deeper structural issues may be harder to tackle and might imply a prolonged period of subdued performance.

- ♦ The impact of sanctions is also felt on the imposing side (in particular Europe). It is worth highlighting that the inclination to amplify assertions regarding the imminent collapse of the sanctioned economy can be partly attributed to the awareness of domestic politicians that their own constituents bear the brunt of collateral damage. With surging energy costs, escalating food prices, and a decline in living standards, the populace endures the repercussions of these measures.[3] Nevertheless, resolute backing for Ukraine persists among G7 & NATO nations.

- ♦ The redirection of raw materials and energy sales towards Asia threatens to create an impasse, impacting Europe's productivity, influence, and

[3] "With respect to Russia, resource prices remained stable, the internal market for Russian firms grew, physical assets were transferred to Russians at preferential rates, and financial assets were retained in the country that might otherwise have gone abroad. With respect to Europe, imported resource prices soared, markets for exports fell, physical assets had to be sold cheaply and financial assets fled to the United States. Thus one would expect improved market conditions in Russia and deterioration in Europe – and this is what we presently observe." (Galbraith, 2023a).

competitiveness (Gavin, 2023). Liquefied Natural Gas is more expensive than pipeline gas (and more liable to happenstance). It is estimated that the effect of the war on European energy costs has gone well beyond the net loss of Russian physical oil and gas streams. Simultaneously, Europe's pursuit of green energy introduces additional challenges, including inevitable higher transition and origination costs and possibly reliability concerns.

- Our lengthy personal experience of the dynamics within Russia leads us to broad agreement with the postulate that the sanctions may well be construed as a 'gift' (Galbraith, 2023 b): When exerted upon a vast, resource-abundant and proficiently skilled nation, "sanctions are isomorphic to a strict policy of trade protection, industrial policy, and capital controls" (ibid.) and they disrupt the influence of foreign economic factors, something the state had long wanted to do but was not in a position to act upon unilaterally.

- The imposition of sanctions has created shortages of foreign components, thereby compelling Moscow to substitute them with lower-grade alternatives. This hampers its capacity to produce, and sustain cutting-edge armaments in Ukraine (Bergmann et al., 2023). Nevertheless, the Kremlin retains a noteworthy level of adaptability in the face of Western actions, skilfully exploiting enormous pre-existing caches of Soviet-era equipment and cultivating relationships with willing nations that furnish it with prohibited dual-use items and technology through a clandestine supply chain network.

- The past months have brought to the forefront the challenges of subjecting a nation as richly endowed with natural resources and technical nous as Russia to an economic siege. Considering existing capabilities and limitations, it will likely persevere on a methodical attrition campaign, putting pressure on NATO to urge Kyiv to negotiate.

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