SANCTIONS, RUBLES, AND OIL: DECODING RUSSIA'S ECONOMIC STRATEGY

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ABSTRACT

Nearly two years after the onset of the conflict in Ukraine, this report provides a comprehensive overview of the current state of the Russian economy. The focus lies on fiscal conditions, external balances, and the impact of Western sanctions on Russia's trade relations with the European Union and select third countries.

Despite heavy military expenditures, Russia managed to keep last year's fiscal deficit in check. The primary source of coverage was the sovereign National Welfare Fund. Notably, EU exports of economically critical (EC) goods and common high-priority (CHP) items to Russia have virtually ceased due to the effectiveness of the sanctions in preventing direct exports. However, third countries—such as China, Hong Kong, Turkey, and the Commonwealth of Independent States (CIS)—have stepped in and increased their market share. These countries now serve as Russia's primary suppliers for missing EC goods and CHP items.

Our findings indicate a significant likelihood of sanctions evasion through CIS countries like Armenia, Kazakhstan, Uzbekistan, and Kyrgyzstan. Although the evasion is less pronounced via Turkey and China, it remains a notable concern.

Keywords: sovereign fund, common high priority items, trade sanctions, sanctions evasion, economically critically goods, energy sanctions

SUMMARY

- Last year, the Russian economy experienced an estimated growth of 3.5%. However, projections for 2024 indicate a slowdown to approximately 1.5%, primarily due to recent monetary policy tightening.

- Despite substantial military expenditures and the erosion of budget revenue caused by Western energy sanctions, fiscal deficits have generally been maintained within manageable limits. The federal government deficit last year was predominantly covered by the National Welfare Fund.

- Increased scrutiny of companies from third countries violating energy sanctions has led to a renewed widening of the price discount on Russian oil in the last few months of 2023.

- There has been minimal change in aggregate Russian import patterns over the past three months. In November 2023, EU exports to Russia of economically critical (EC) goods and common high-priority (CHP) items were at a mere 2% of pre-war values, indicating the effectiveness of sanctions in preventing direct exports.

- Apart from China and Hong Kong, Türkiye and the CIS countries have emerged as Russia's most significant suppliers of missing EC goods and CHP items. Our findings suggest a particularly high likelihood of sanctions evasion through CIS countries such as Armenia, Kazakhstan, Uzbekistan, and Kyrgyzstan, with a lesser extent via Türkiye and China.

ECONOMIC LANDSCAPE

The Russian economy grew by 3.5% last year, exceeding analysts' predictions. The growth was higher than expected due to short-term resilience to monetary tightening. In Q4 2023, economic growth remained solid, with elevated consumer and business confidence. Key indicators include a 10% increase in gross fixed capital investment, 5.9% growth in retail trade turnover, 7.7% higher average real wages, and a 4.8% rise in real disposable income.

In 2023, the Russian economy experienced notable developments in its industrial sectors. Manufacturing grew by 7.5% during the first 11 months, with industries related to military output showing above-average growth rates. Sectors such as computers, electronic and optical products, other transport vehicles and equipment, finished metal products (excluding machinery and equipment), and electric equipment contributed significantly to this expansion. However, mining output declined by 1.1%, primarily due to falling natural gas production. Remarkably, oil production remained resilient despite sanctions, with shipments reoriented toward Asia (particularly China and India). Overall, industrial production saw relatively modest growth at 3.6% during the same period.

The rapid growth of wages in Russia is attributed to a tight labour market. Unemployment decreased significantly, reaching an all-time low of 2.9% in November 2023. However, labour shortages are acute in the industrial sector, with 47% of companies reporting shortages of skilled workers. Factors include demographic trends, military mobilization, and the shift toward manufacturing due to increased military procurements and Western company withdrawals. Workers from service sectors are moving to manufacturing for higher wages.

Economic recovery, which performed well last year, is expected to lose momentum in 2024 and beyond. Projections indicate sharp deceleration in GDP growth to 1.4% (according to Focus Economics) or 1.5% (wiiw forecast). Factors contributing to the slowdown include last year's monetary policy tightening impacting private consumption and investment, labor shortages, and the global economic slowdown. Growth in 2025-2026 is likely to remain below 2%, reflecting capacity constraints.

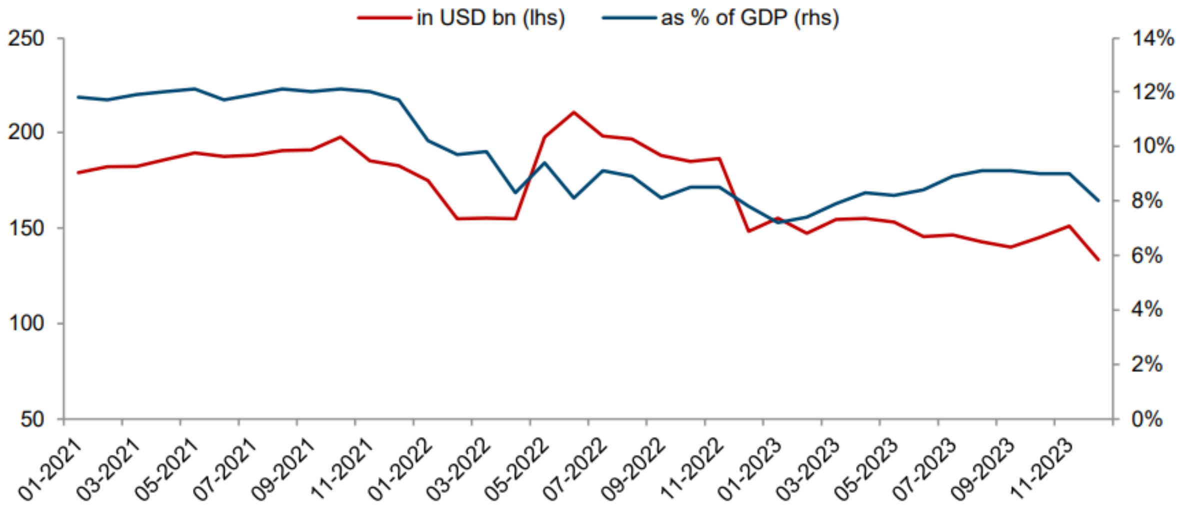
FISCAL DEFICIT: NATIONAL WELFARE FUND TO THE RESCUE

In 2023, the federal government's deficit decreased to 1.9% of GDP (from 2.1% in 2022), aligning with the 2% target. This positive outcome was due to strong non-energy revenues, which surged by 25% year on year, driven by rapid economic recovery. Predictably, energy revenues from the budget declined by 23.9% due to lower oil prices compared to 2022. Western energy sanctions and reduced natural gas exports contributed to this decrease.

Despite challenges such as higher military spending and erosion of government revenue, the budget deficit remained manageable. This is noteworthy for Russia, which historically maintained budget surpluses before the war. The sovereign National Wealth Fund (NWF) played a crucial role in covering the deficit. In 2023, 90% of the federal budget deficit was financed from the NWF. Notably, the NWF saw sales of EUR 537 million, CNY 115 billion, and 233 tonnes of gold in December.

Although the NWF adhered to the 'budget rule' (details in Box 1) and recorded net inflows, it declined by 10% in USD terms during 2023. The liquid part of the NWF, consisting of foreign exchange and gold, experienced a significant 36% plunge.

Figure 1 / National Welfare Fund in 2021-2023, end of the month



Source: Ministry of Finance.

As of January 1, 2024, the National Welfare Fund (NWF) held USD 133.4 billion, equivalent to approximately 8% of the estimated 2023 GDP. Within the NWF, the liquid portion accounted for USD 55.9 billion, representing around 3.3% of GDP. Notably, this liquid part is entirely denominated in Chinese renminbi and gold. The fund's composition has undergone significant changes since the war began, with a reduction in diversification. While this decrease minimizes vulnerability to Western financial pressure, it introduces risks tied to the renminbi exchange rate. The remaining non-liquid assets primarily consist of equity and bonds from Russian companies, with Sberbank being a notable holding.

During the ongoing conflict, the NWF has played a crucial role in financing various initiatives. These include infrastructure projects such as highway construction, the acquisition of foreign-owned aircraft by Russian airlines (following lease contract terminations by foreign providers), and recapitalization efforts for state-owned banks and corporations. Entities like Aeroflot, Russian Railways, and VTB bank have benefited from NWF support.

Under two key assumptions—similar federal budget deficits in 2024-2025 and no replenishment of the NWF under the budget rule—the liquid part of the NWF may be fully depleted by the end of the upcoming year. However, this depletion does not imply that the government will lack funds for ongoing conflict in Ukraine beyond 2025. The government still has the option of domestic borrowing, as demonstrated in 2023 when RUB 2.5 trillion was raised through government bonds. The current government plan for 2024 involves borrowing a total of RUB 4.1 trillion, with RUB 1.5 trillion allocated for debt repayment.

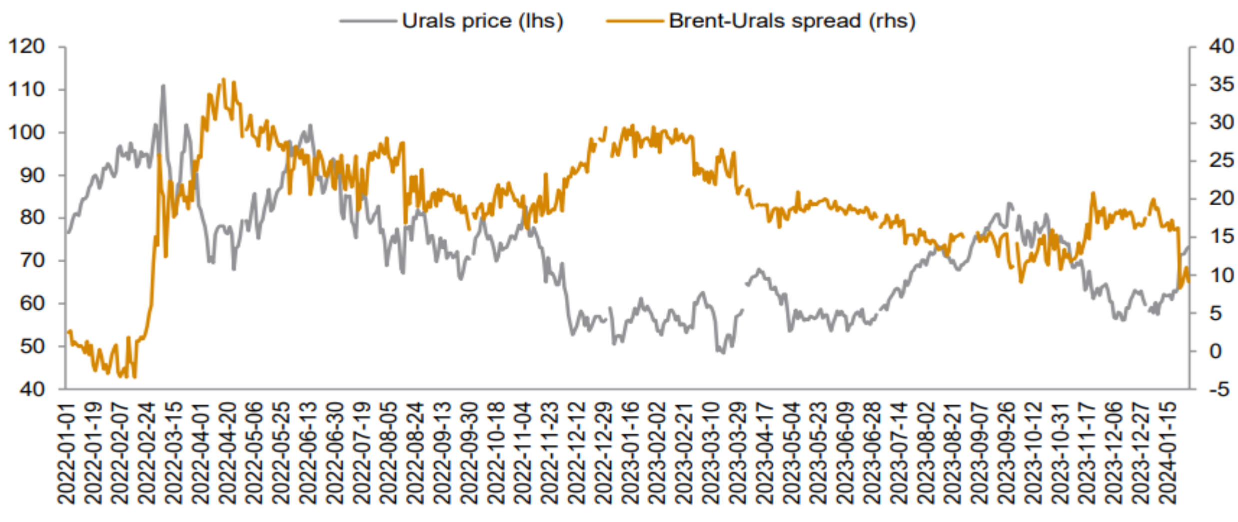
Resurgence of Western Energy Sanctions

Preliminary estimates from the central bank indicate that last year's current account surplus was a mere USD 50.2 billion, significantly lower than the 2022 value of USD 238 billion. Relative to GDP, this corresponds to a decline from 10.5% to an estimated 2.8%. The primary reason for this shrinking external surplus lies in unfavourable trends in foreign trade, specifically falling exports and rising imports.
Goods exports decreased by 28.6% year on year, while goods imports increased by 10.1%. Consequently, the trade surplus in goods fell by 62%.

Similar trends were observed in services trade. Exports declined by 16.7%, and imports rose by 4.5%. The increase in imports partly resulted from a modest recovery in the number of Russians traveling abroad. As a result, the trade deficit in services expanded. However, the improved income balance compensated for this, with foreign income from Russia declining more sharply (-26.5%) than Russian income from abroad (-14.4%).

Recent trade data sheds light on Russia's revenue from energy exports and the impact of Western energy sanctions. Initially, these sanctions significantly affected the price of Russian oil, but their impact gradually diminished over time. However, recent developments suggest a reversal: the price spread between Russia's Urals crude oil and the benchmark Brent has increased again. After hitting a low of USD 9 per barrel in early October, it reached USD 20 per barrel by early January (although it has since declined). This shift can be partly attributed to increased scrutiny by the US Treasury, enforcing secondary sanctions on companies violating the USD 60 per barrel price cap set in December 2022 for Russian oil shipments to third countries.

Figure 2 / Urals oil price and the spread to Brent, in USD per barrel, 2022-2024



Source: Investing.com.

Due to increased discounts and declining global oil prices, the average price of Russian oil sharply decreased in the last months of 2023. It went from USD 80.2 per barrel in October to USD 64.1 in December. Despite higher shipment volumes, Russian oil export revenue hit a low of USD 14.4 billion in December. These developments highlight the impact of energy sanctions, especially when effectively enforced against third countries aiding Russia in circumventing Western sanctions. Such measures can significantly undermine Russia's energy revenue and overall fiscal situation.

CHANGE IN RUSSIAN IMPORT PATTERNS

We analyze Russia's monthly imports in real USD terms, starting from January 2021. Our data sources include aggregated import flows from the Russian National Bank and disaggregated trade statistics from national sources (mirror statistics) and UN Comtrade data. These sources cover 67 countries (EU27 plus 40 others) at the HS6 product level, accounting for 83% of all Russian imports in 2019. To determine the sanction status of products, we refer to the ifo sanctions database.

General Trends:

- Overall, recent import trends show a rebound, aligning closely with pre-war figures.
- Sanctioned products are barely exported, but the EU27 continues to export unsanctioned goods to Russia (USD 2.7 billion in November 2023).
- China has solidified its position as Russia's primary supplier, especially for goods subject to Western sanctions.
- The Commonwealth of Independent States (CIS) countries and Türkiye have gained relative importance.

Interesting Developments for Sanctioned Goods: Between July and September 2023, Armenia, Kyrgyzstan, Georgia, and Uzbekistan experienced notable changes in their trade dynamics related to sanctioned goods. These developments warrant closer examination.

In August 2023, Russia experienced a surge in imports from Armenia, primarily due to an increase in large aeroplanes (HS6 product: 880240) valued at USD 12 million. Notably, before the war, the EU27 and other sanctioning countries exclusively supplied this product to Russia. Reports have highlighted challenges faced by Russia's aerospace industry, particularly related to replacing aging aircraft. Interestingly, this sudden increase in Armenian exports marked the first significant import of this product by Russia in our database. Previously, negligible import volumes were observed from China and India for the same product. Despite its significance, the import of airplanes from Armenia in August 2023 represents only 5% of pre-war average monthly import volumes from the EU27, indicating potential supply difficulties.

In June 2023, Russia experienced a sudden increase in imports from Kyrgyzstan, specifically related to a specific type of boring-milling machine (HS6 product: 845941). Interestingly, demand for this product had been consistently low in all other months, including the pre-war period, with average monthly Russian imports amounting to only USD 0.4 million. However, in June 2023, sales from Kyrgyzstan spiked significantly, reaching USD 29 million. This drastic change could indicate either a profound shift in preferences due to the war or potential misclassification, hinting at illegal activities. Additionally, the time series for Georgia in July 2023 shows a notable increase in the import of yachts (HS6 product: 890399). This sudden surge in yacht imports from Georgia reflects changing consumer preferences or market dynamics during the ongoing conflict. Furthermore, in July 2023, Uzbekistan experienced higher imports of specific products: chlorates (HS6 product: 550320) and electrical lighting (HS6 product: 381512). In September 2023, Uzbekistan saw increased imports of polyester staple fibres (HS6 product: 282911) and supported catalysts (HS6 product: 851220). These shifts in import patterns may have implications for industrial or consumer sectors within Russia.

EU EXPORTS OF SANCTIONED GOODS TO RUSSIA VIRTUALLY STALLED

Since the beginning of 2021, Russia has faced EU sanctions targeting specific categories of goods. These include two distinct lists: EC goods and CHP items. The EC goods list comprises 72 HS6 products suspected of potential sanctions evasion through third countries. These products fall into four sections: machinery and electric equipment, vehicles, aircraft, vessels, precision instruments, and chemical products. In contrast, the CHP items list contains 41 critical items related to Russia's weapons systems and military development. Notably, these two lists do not overlap. The EU's aim is to regulate trade flows and prevent sanctions evasion in response to Russia's actions in Ukraine.

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By September 2023, all EC goods and CHP items faced sanctions, albeit partially. However, for some HS6 products, determining the sanction status remains ambiguous due to trade restrictions applying only to a subset of items within the same HS6 product group.

Regarding CHP items:

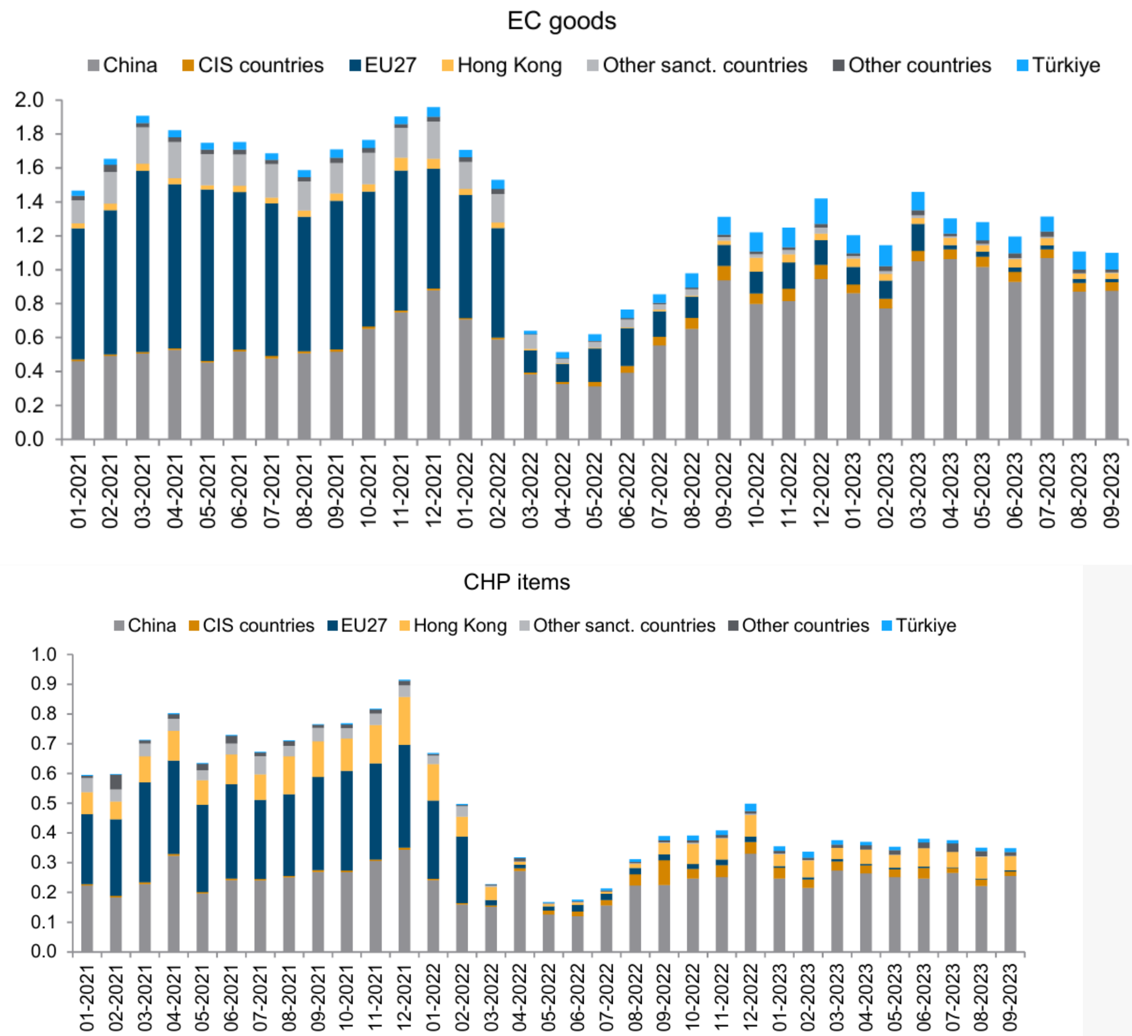
- In March 2022, only 2% were fully sanctioned, and 19% were partially sanctioned.
- Subsequent rounds of sanctions broadened their scope, resulting in 98% of the 41 CHP items being fully sanctioned by September 2023, with one HS6 product partly sanctioned.

As for EC goods:

- By March 2022, partial sanctions covered all EC goods.
- Over time, the share of fully sanctioned EC products increased to 82% by September 2023, leaving 14 HS6 products partially sanctioned.

Notably, our data confirm that sanctions effectively curtailed direct exports. Russian imports from the EU27 became negligible once an HS6 product faced complete sanctions. The positive export flows from EU27 member states after March 2022 were attributable to HS6 products not fully sanctioned at the time. These fluctuations corresponded to the more restrictive stages of the EU's sanctions regime following the initial round triggered by the Russian invasion of Ukraine in February 2022 .

Figure 3 / Russia's imports by country group, in USD billion (real, 2018)



Notes: We use the definition provided by the EU Commission for economically critical (EC) goods as of 18 October 2023 and for common high-priority (CHP) items as of 24 October 2023. Trade data presented in the figure cover a large share of total Russian imports. CIS countries include Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Moldova and Uzbekistan.
Source: UN Comtrade, national sources.

THIRD COUNTRIES INCREASE THEIR MARKET SHARES

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China has significantly strengthened its trade relations with Russia, emerging as the primary source for substituting missing imports from the EU27 and other sanctioning countries. In 2021, Chinese exports of economically critical (EC) goods to Russia were notably concentrated, with laptops accounting for nearly one-third of total EC goods imports from China. Over time, the product scope expanded to include vehicles (especially various types of trucks) and vehicle parts. By September 2023, Russia imported 1.6 times more EC goods from China than the average monthly figure in 2021. However, imports of common high-priority (CHP) items from China remained relatively stable, revealing heterogeneity across tiers. While Tier 1 and Tier 4 imports increased (reaching six times the 2021 levels in December 2022), Tier 3b offset this trend.

For high-tech products, particularly semiconductors (Tier 1), Hong Kong plays a crucial role. Exports of Tier 1 products from Hong Kong increased by an average of 14% compared to the pre-war level. Notably, this growth was driven solely by electronic integrated circuits, which increased by 48%, while other Tier 1 products declined (-3%).

Türkiye (Turkey) primarily supplies EC goods to Russia. Since January 2023, Turkish exports of EC goods to Russia have more than doubled the 2021 average. During the months following the Russian invasion, Türkiye accounted for 8% of EC goods imports and 3% of CHP items. Türkiye's significance lies in providing

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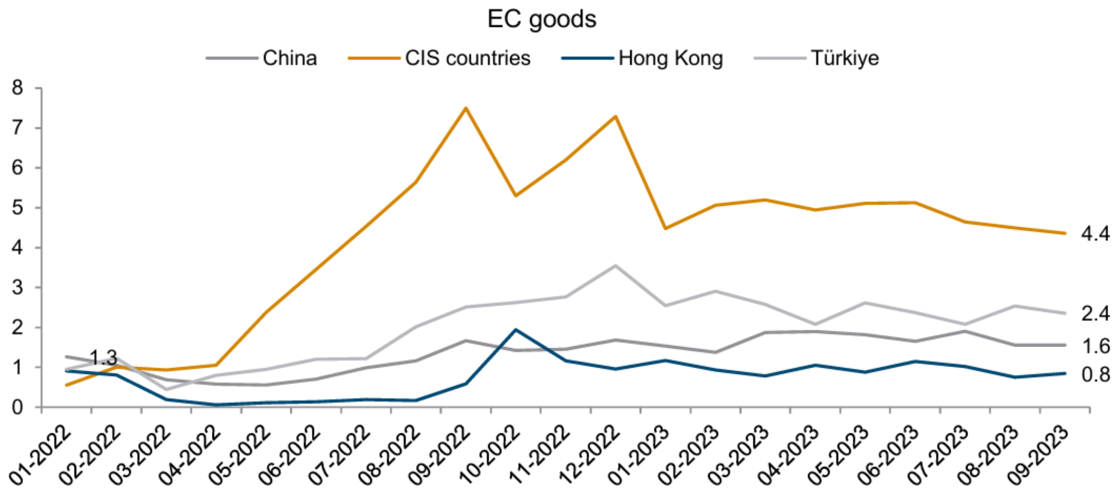
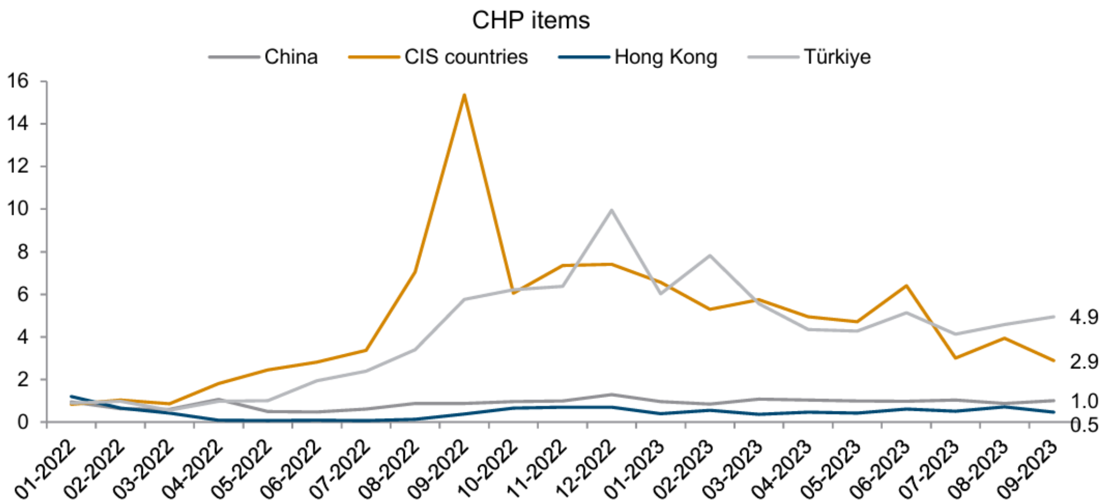
In the aftermath of the war, Kazakhstan's role as a hub for re-exporting economically critical (EC) goods and common high-priority (CHP) items to Russia somewhat diminished. Simultaneously, other Commonwealth of Independent States (CIS) countries gained prominence as trade partners. Notably, Armenia significantly increased its exports to Russia, particularly in communication apparatus (HS6 product 851762), which reached 96% of total Armenian CHP item exports by August 2023. Armenia also entered the EC goods export market, with 39 products previously unexported to Russia (or exported at very low levels).

While third countries generally don't prominently supply Russia with EC goods or CHP items, intriguing patterns emerge for specific products. For instance, ball and roller bearings—critical components for tanks and military vehicles—were once provided by the EU27 and the US. Within Tier 3b of CHP items (mechanical components), ball and roller bearings constitute 80% of total imports. Remarkably, even without Western supplies, Russia's imports of these bearings remain comparable to pre-war levels. Apart from China, CIS countries (primarily Kazakhstan) play a crucial role. Additionally, India, Malaysia, and Serbia have emerged as reliable partners. Serbia, in particular, exports approximately 50% of its CHP products to Russia in the form of ball and roller bearings. Furthermore, since the war's onset, Serbia has begun exporting 18 new EC goods and five new CHP items. India also stands out as an important source for specific products (such as hydrogen and parts for airplanes and helicopters), albeit intermittently. While the absolute numbers are currently modest, this trend warrants close monitoring in the coming months .

Figure 4 / Russia's imports from most important third countries (average 2021 level = 1)





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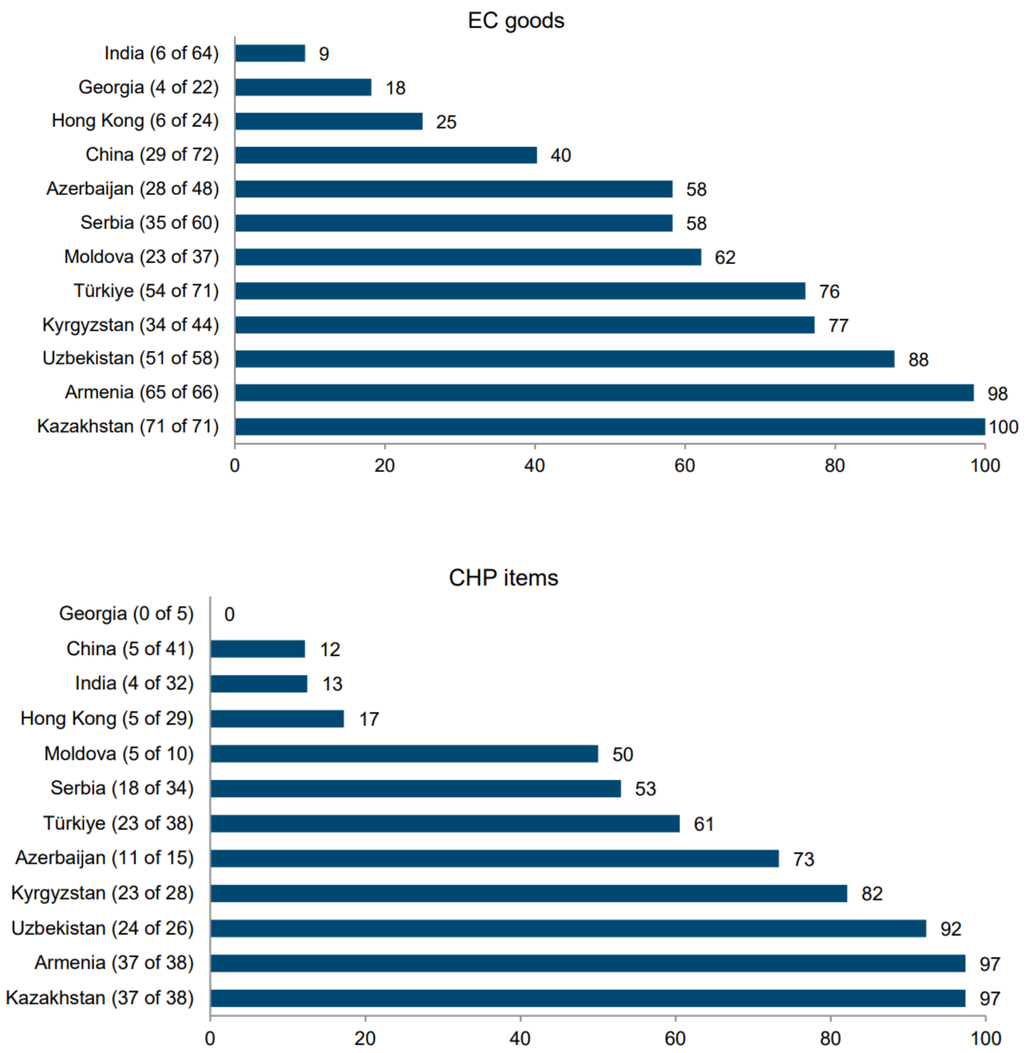
Source: UN Comtrade, national sources.

INDICATIONS OF SANCTIONS EVASION

To assess the surge in exports, researchers normalized the total value of exports to Russia by considering each country's worldwide exports in 2019. If a country significantly produces a particular HS6 product globally, the increase in exports to Russia is likely due to higher domestic production. The normalized share should be lower than one if sanctions evasion is occurring.

Figure 5 / Share of HS6 products exported to Russia in 2022 with high likelihood of sanctions evasion, in %



Note: The chart shows the share of products (in %) across origin countries in 2022, for which the respective country's yearly exports to Russia exceeded its exports to all destinations in 2019 by at least 50 times. The normalisation measures the likelihood of sanctions evasion. We use the definition provided by the EU Commission for economically critical (EC) goods as of 18 October 2023 and for common high-priority (CHP) items as of 24 October 2023.

Figure 5 summarises the findings and shows that, especially for the CIS countries, the data indicate a particularly high likelihood of sanctions evasion: for Armenia, Kazakhstan, Uzbekistan and Kyrgyzstan, exports to Russia were at least 50 times greater than their exports to all destinations in 2021 in the case of almost all exported goods – both EC goods and CHP items. Our method also hints at sanctions evasion by Türkiye and China, although it is less extreme than for the CIS countries. For India, sanctions evasion seems less prevalent: for EC goods, only six out of 64 products show anomalously high exports to Russia, and for CHP items the figure is four out of 32. Of course, this finding could simply mean that India is, in fact, redirecting existing exports to other destinations to service the greater demand from Russia. Alternatively, it might be possible that the transport routes for possible evasion are, as yet, not fully developed, making it unprofitable to circumvent sanctions through India.

CONCLUSION

In this study, we explored the dynamics of Russia's economy amidst geopolitical challenges and shifting global landscapes. Key takeaways include:

Resilience Amidst Sanctions:
- Despite Western sanctions, Russia's economy grew by 3.5% in 2023.
- Industrial performance and strategic trade reorientation contributed to this growth.

National Welfare Fund (NWF):
- The NWF played a critical role in managing fiscal deficits.
- However, its liquid assets have significantly declined.

Trade Diversification:
- While EU sanctions curtailed direct exports, third countries (China, Turkey, CIS nations) stepped in.
- Concerns arise regarding sanctions evasion.

Challenges Ahead:
- Labor shortages and monetary tightening may impact future growth.
- Geopolitical tensions remain a risk factor.

Recommendations:
- Invest in innovation and diversification for sustained growth.
- Monitor geopolitical developments closely.

In summary, Russia's resilience will be tested as it navigates ongoing challenges. Further research should explore long-term strategies and sector-specific impacts.

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