GLOBSEC Russia Sanctions Update

By Vladimir Milov

How is the Russian economy doing 19 months after Putin began his full-scale invasion of Ukraine? Many voices argue that the sanctions have had only a limited impact and are not truly working, that the Russian economy has been "resilient", and that Russia is successfully restructuring its economy, decoupling from the West.

These optimistic estimates are primarily made in comparison to some hotheads' initial assumption that the Russian economy would "collapse" as a result of sanctions - which it didn't. However, by any objective indicator, Russia faces severe and growing economic troubles and multiple crises, and the situation continues to progress over time. It means that sanctions are having their effect, albeit not immediate - but, with the necessary patience, it may further complicate Putin's ability to wage war and the Russian domestic political situation.

Earlier this year, most experts predicted that the key economic problem Russia would face is the budget crisis caused by the Western oil embargo, oil price cap, and a sharp plunge in revenues. That is indeed happening, but more importantly, it led to the plunging ruble exchange rate and the resulting inflation – now the top economic challenge. The ruble has lost about half of its value since mid-2022 and continues on its devaluation trajectory; this drastically affects domestic prices, as Russia still continues to import the bulk of consumer and investment goods. Inflation, which was projected by the Russian authorities at the beginning of the year to be tamed to 4% by early 2024, is now projected to reach 7.5% by the end of 2023[1] and keeps increasing[2]. As a result, since mid-July, the Russian Central Bank had to nearly double the interest rate from 7.5% to 13%, promising further rate hikes and announcing a "protracted period of tight monetary policy". Russian business has already lambasted this policy as "putting an end to hopes for economic recovery"[3].

Why does the ruble keep losing its value, and what do sanctions have to do with this? The reasons are fundamental: due to the cutoff of Russia from Western technologies and intermediary goods supply chains, Russia cannot launch the long-promised import substitution - and the country is forced to turn to imports of consumer and industrial goods from the countries of the Global South. Imports have soared in past months - which was seen by many as a worrisome sign of circumvention of Western sanctions. Circumvention does indeed take place and should be shut down, but the key immediate effect of the surge in imports - which have returned to pre-invasion levels - was the strong "currency hunger" because export revenues plunged (according to the Russian Ministry of Finance, Russian oil and gas export revenues have contracted by 34.5% year-on-year after nine months of 2023[4]).

This effect will likely linger: Russia badly needs imports to keep its economy going, but export revenues, despite all the fluctuations, will be severely depressed due to Western sanctions against major Russian export commodities. Russia's bet to transfer to ruble payments for imports is not materializing: the share of the ruble

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[1] TASS, "Ministry of Economic Development raised the forecast for inflation in Russia in 2023 to 7.5%" (https://tass.ru/ekonomika/18734001)
[2] Interfax, "Inflation in the Russian Federation in September amounted to 0.87%, the annual rate accelerated to 6%" (https://www.interfax.ru/business/925376)
[3] Kommersant, "Boris Titov on raising rates: The Central Bank responds to immediate challenges, but does not create conditions for development" (https://www.kommersant.ru/doc/6222705)
[4] Russian Ministry of Finance, "Preliminary assessment of federal budget execution for January-September 2023" (https://minfin.gov.ru/ru/press-center/?id_4=38703-predvaritelnaya_otsenka_ispolneniya_federalnogo_byudzheta_za_yanvar-sentyabr_2023_goda)

in import invoicing has stayed flat at around 30% for the past couple of years, and the sharp plunge in the share of dollars and euros is mainly substituted by the rise of the share of Chinese yuan, and some other currencies. The ruble has failed to gain international demand because it is not an attractive currency. After the beginning of Putin's full-scale invasion of Ukraine, Russia's Central Bank introduced draconian capital controls and regulations, effectively destroying the ruble's free convertibility. Moreover, with sharp exchange rate fluctuations and high exposure to currency risk - who would want to use that kind of currency for transactions? This is why the ruble will inevitably continue to devalue, but there are also other factors at play, including continuing capital flight (forecast to remain at the level of $40-70 billion per year in 2023-2025 by the Russian Central Bank[5]), and ongoing exits of Western businesses from Russia, for example.

The only factor that currently provides a lifeline to the Russian authorities is the increasing revenues from oil exports. According to the Russian Ministry of Finance, in September 2023, the average monthly price of a major Russian crude export blend, Urals, reached $83 per barrel[6], meaning that the G7 oil price cap - set at $60 - is obviously not working. It is a long discussion of why this is so - but, as per the author's opinion, the key factor is the G7's inability to enforce it in the first place. Indeed, enforcement of the G7 oil price cap requires monitoring tens of thousands of transactions with shipping companies, insurers, and other bodies, most of whom do not represent G7 countries. The G7 simply does not have that scale of sanctions enforcement capacity. Nevertheless, even the growth in oil prices does not seem to help solve Russia's currency deficit problem. – it would take oil prices to surge well beyond $100 per barrel for a prolonged period of time, which is not likely due to the depressed global economic situation. It may only become realistic under a dramatic scenario, such as the protracted war between Iran and Israel, and Russia will not be able to recover the revenues from natural gas exports lost due to decoupling from the EU gas market (there is no infrastructure to supply Gazprom's piped gas elsewhere).

Aside from continuous ruble depreciation, nearly all other key economic factors, according to the Russian Central Bank, are pro-inflationary: budget deficit spending, expansion of domestic credit, increasing costs of logistics for trade with Asia, and, last but not least, a severe deficit of skilled workforce - which drives labour costs up - caused by Putin's war, mobilization, and related mass emigration. Disinflationary factors are clearly absent. It means that the inflation will linger, forcing the Central Bank to keep interest rates high and killing any potential recovery[7].

So what about the budget crisis? So far, it has been avoided, but at a cost. After nine months of 2023, the Russian Ministry of Finance brought the federal budget deficit down to RUR 1.7 trillion (1% of the GDP) - just 58% of the planned annual deficit of RUR 2.9 trillion (2% of GDP)[8]. After five months, the federal deficit reached nearly 100% of the planned annual level - but later, it was seemingly tamed. However, there should be no illusions about this situation: a significant share of budgetary outlays is traditionally financed in December, and the materials for the draft 2024 budget suggest that the Russian government plans to exceed the RUR 3 trillion deficit mark this year, drawing down some RUR 2.5 trillion from the National Wealth Fund (NWF) to cover it. That is about 35% of the remaining "liquidity funds" of the NWF - real cash on the government's accounts; the remaining portion of the NWF is invested into various shares and bonds of Russian state companies and cannot be immediately recovered.

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[5] Vedomosti, "Nabiullina assessed the outflow of capital from Russia" (https://www.vedomosti.ru/economics/news/2023/04/12/970597-nabiullina-otsenila-ottok-kapitala-iz-rossii-v-mlrd)
[6] Russian Ministry of Finance, "On the average price of Urals crude oil" (https://minfin.gov.ru/ru/press-center/?id_4=38692-o_srednei_tsene_na_neft_marki_urals)
[7] Kommersant, "Boris Titov on raising rates: The Central Bank responds to immediate challenges, but does not create conditions for development" (https://www.kommersant.ru/doc/6222705)
[8] Russian Ministry of Finance, "Preliminary assessment of federal budget execution for January-September 2023" (https://minfin.gov.ru/ru/press-center/?id_4=38703-predvaritelnaya_otsenka_ispolneniya_federalnogo_byudzheta_za_yanvar-sentyabr_2023_goda)

Moreover, the deficit was reduced only by bringing monthly federal spending down to around RUR 2 trillion from May to September, as opposed to RUR 2.8 trillion on average from January to April[9]. But limited government spending also puts brakes on the model of economic recovery based on government spending: it is no coincidence that the growth in industrial and agricultural sectors has significantly slowed in the past three months after federal spending was reduced to contain the deficit. For the next year, federal spending on economic subsidies is planned to be cut by 5%, or from 2.5% to 2.2% of the GDP[10].

The desire to keep the rainy day financial reserves untapped will inevitably lead to tax increases, particularly given Putin's desire to sharply increase military spending between 2024 and 2026[11]. That is based on the assumption that federal revenues will grow by over 22% in 2024[12] - which is not borne out by any credible economic forecasts. The government's own budget projections suggest the Urals oil price to be slightly above $70 per barrel and GDP growth just over 2% in 2024 - which simply cannot ensure 22% revenue growth. Markets widely expect[13] (which is supported by some hints in the draft budget supplementary materials) that the additional revenues in the amount of over RUR 6 trillion (some 3.5% of the GDP) will come from tax increases. Needless to say, tax hikes - alongside interest rate hikes - will severely curb investment and economic recovery.

Investment is key to understanding the future dynamics of the Russian economy. First, foreign investment has been dead since the beginning of the full-scale invasion of Ukraine. Notably, there have been zero investment entries into Russia by investors from China, India, the Middle East, and other countries of the Global South. Capital continues to flee Russia in dozens of billions of dollars per year. The Russian economy only relies on domestic investment, but here, again, the picture is largely driven by state-linked and military-related sectors: according to Rosstat, in the first half of 2023, investment was largely driven by such sectors as "public administration and military security" (up 75% as compared to the first half of 2022); "computers, electronic and optical products" (radar devices, radio electronics; up 54%), "finished metal products other than machinery and equipment" (weapons and ammunition; up 42%); "railroad transport" (38%), etc. In the "civil" areas of the economy - agriculture, trade, food production, medicines, furniture, rubber and plastic products, etc. - investment is down compared to the relevant period of 2022.

Lack of investment will be critical to curbing the prospects for a Russian economic recovery. Foreign investment is not coming - neither from the West nor the Global South, as they do not see any upsides of investing in Russia today and are scared off by draconian wartime capital controls and regulations. Private investment is squeezed by increasing taxes, raising inflation and high interest rates. State funds are only available so long as the government still has some financial reserves left - which will inevitably be depleting. There is no further model for development - Russia can only hold on for some time, and this ability is likely to wear thinner by Putin's announced military spending hikes.

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[9] Ibid
[10] RBC, "Expenditure Transformation. How the government will redistribute budget spending in 2024" (https://www.rbc.ru/newspaper/2023/09/26/65117eaf9a7947300ad43fab)
[11] In more detail: Vladimir Milov, "Bleeding Russia dry: How Putin's inflated war budget will lead to economic ruin", The Insider (https://theins.press/en/opinion/vladimir-milov/265562)
[12] Vedomosti, "Finance Ministry forecasts an increase in tax revenues by 14% next year. The draft budget expects revenue growth to be 22% in 2024" (https://www.vedomosti.ru/economics/articles/2023/09/25/997000-minfine-sprognozirovali-rost-postuplenii-nalogov)
[13] BKS Express, "First draft budget: revenue growth and increased defense spending" (https://bcs-express.ru/novosti-i-analitika/pervyi-proekt-biudzheta-rost-dokhodov-i-uvelichenie-raskhodov-na-oboronu-v-2024-godu)

The above suggests that Western sanctions against the Russian economy have a lasting, progressively increasing, and systemic effect. There is so much more to be done. Some major Russian export commodities worth tens of billions of dollars in exports, such as diamonds, metals, nuclear fuel and services, still remain unsanctioned, generating significant revenues. Russia is somewhat successful in circumventing the sanctions through the countries of the Global South - which means that there is a lot to be done in shutting down these circumvention routes - to begin with, Western countries need to significantly boost staff and capacities dedicated to monitoring the compliance with sanctions and their enforcement. The oil price cap is not working, requiring a comprehensive review and development of measures to enforce it.

But generally, the Russian economy is facing multiple troubles and mounting crises - it is wrong to say that sanctions have no effect. Ask Russian businesses what they think about inflation, exchange rate, tax and interest rate hikes.