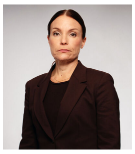
BLOG

Russia's economy after a year of war and sanctions

1 Mar 2023 – Russian economy



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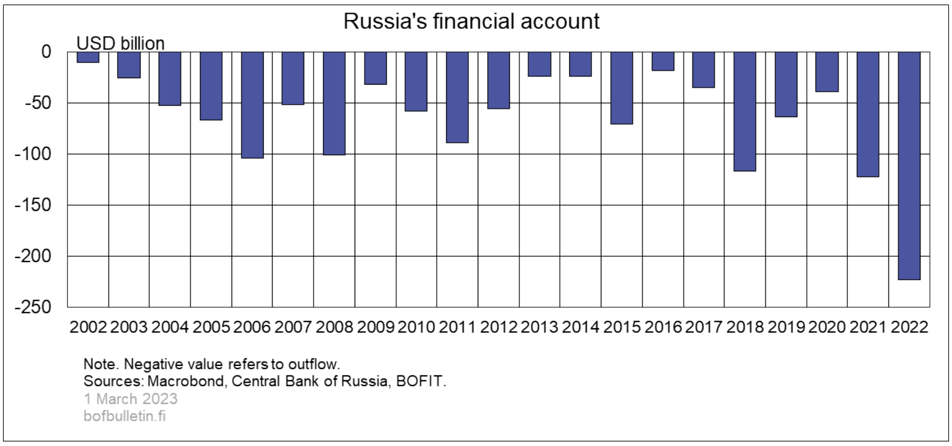
Russia's brutal war in Ukraine has already lasted a year. In response to an unprovoked invasion, a coalition of countries led by the European Union and the United States imposed extensive economic sanctions on Russia. Key aims of the sanctions are to limit its financial and military capabilities to wage war. The sanctions target sectors, companies and individuals considered critical in sustaining Russia's war effort.

Financial sanctions have led to the freezing of a large part of Russia's currency reserves (including a large chunk of the liquid assets in the National Wealth Fund). Severe restrictions have been imposed on lending to the Russian government as well as numerous banks and corporations. Many large Russian banks have been excluded from the SWIFT international payment messaging network. Financial sanctions have severely restricted Russia's access to foreign financing. They have also complicated Russia's ability to conduct foreign trade and other business with foreign counterparties. Capital outflows from Russia in 2022 were historically large despite the imposition of rigorous capital controls (Chart 1).

Chart 1.



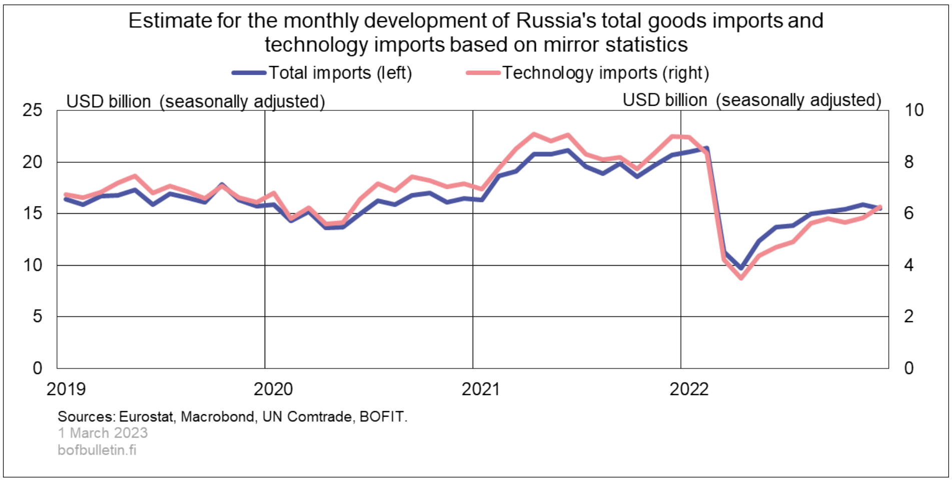
Russia's financial capabilities are also targeted by the sanctioning countries with restrictions on imports from Russia. Last year, the impact on Russian exports was limited because key restrictions have often been implemented with significant lags. Oil and gas, which represent roughly half of Russia's goods exports, also account for about 40 % of Russia's federal budget revenues (taxation of oil & gas production and exports). The EU has been Russia's main export market.

The EU has yet to impose restrictions on imports of natural gas from Russia, but restrictions on imports of Russian crude oil and petroleum products are now in effect (December 2022 and February 2023, respectively). The EU initially planned to ban provision of services for sea transport of Russian oil to cut Russia's oil exports to other markets, but opted instead for a price cap mechanism that allow the EU and G7 countries to mitigate the effects on global markets. The mechanism bans provision of services only for such shipments where the purchase price of oil exceeds the cap (currently 60 dollars a barrel). The aim of the price cap mechanism is to keep the volumes of Russian oil exports largely unchanged, while lowering the export price of Russian oil and thereby Russia's export and tax revenues.

Russia's export revenues, supported by high commodity prices and export volumes, peaked in 2022. Late last year, export revenues started to decline. Since EU import restrictions and the price cap entered into force, the volume of Russia's crude oil exports has declined a bit, while the price of Urals oil has fallen substantially. Indeed, Russia has been forced to grant substantial discounts just to be able to sell its oil. In January 2023, the average price of Brent crude was about 80 dollars a barrel, while, according to Russia's Ministry of Finance, the price of Russian Urals crude was just 50 dollars barrel.

The restrictions on exports to Russia seek to reduce the technological capabilities of Russia's military industry. In particular, restrictions focus on those high-tech goods and materials that can be used by Russia's military industry. Russia's total goods imports were in December 2022 down by about 20 % on year, while technology imports were off by about 30 % (Chart 2).

Chart 2.



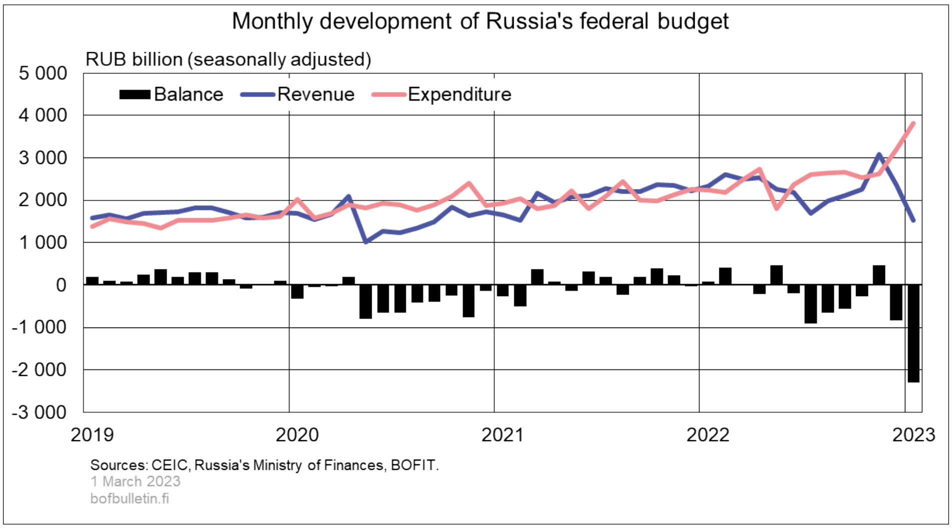
While there are no recent public data available on production of Russia's military hardware, the output of many other machinery and equipment has contracted sharply. Last year, for example, passenger car production was down 67 %, excavators down 53 % and television receivers down by 36 %. The collapse suggests that export restrictions are hitting those branches that rely most on imported inputs and machinery. However, there are also reports on some cases that sanctions have been circumvented, which means that Russia's defence contractors have had access to certain sanctioned goods. Preventing such schemes is obviously of utmost importance to keep the sanctions regime potent.

According to preliminary estimates, Russian GDP contracted 2 % in 2022. The blow to the Russian economy from the war and sanctions was softened by the Central Bank of Russia's prompt response with heavy-handed measures that prevented a full-blown financial crisis, as well as a sharp increase in government spending and record-high export revenues. The industries hit hardest by lack of imports account for a small part of Russia's commodity-driven economy.

Average Russian began to see the effects of war and sanctions reflected in their personal economic situation last year. The volume of retail trade, a proxy for goods consumption, declined by 6 % in 2022. At the same time, consumer prices increased 14 % and the average purchasing power of Russian households diminished. The direct effect of sanctions on Russian population is limited, however, as sanctions target specific sectors rather than the wider economy. The government has also cushioned the blow for households by increasing social spending.

Russia's public finance situation has tightened gradually. The federal budget turned to deficit in 2022 reaching 2 % of GDP. In January 2023, the deficit widened substantially further. Budget revenues, led by oil and gas income, dropped sharply, while expenditures jumped dramatically. Russia's budget plans quite optimistically call for a deficit of just 2 % of GDP this year. Russian government can likely deal even with a larger budget deficit as it can borrow from domestic banks or have the central bank also print money as needed. Such financing has its limits and increases risks for the economy, but it can be used for some time.

Chart 3.



The war and sanctions have led to a recession in the Russian economy. Financial sanctions have cut Russia from foreign financing and Russia's access to technology is severely restricted by export bans. The full effect of import restrictions on Russian goods has yet to manifest as key restrictions on crude oil and petroleum products only entered into force recently. The price cap mechanism seeks to reduce the price, rather than volume, of Russian oil to avoid distortions in global markets. While it is important to take into account the global effects of sanctions, such compromises in the sanctions regime also tend to dampen the effect on the Russian economy.

Sanctions already imposed and properly implemented have had a substantial effect on targeted sectors. They have proven to be an important tool in restricting Russia's ability to wage war. Nevertheless, sanctions alone cannot stop Russia from continuing its war of attrition. Ukraine will thus need constant financial and military support in its efforts to defend itself from Russia's onslaught.

Tags

Ukraine, Russia, war, BOFIT, sanctions