The Russian Economy Is Muddling Through the Sanctions War

by Oleg Buklemishev

ABSTRACT

The transatlantic campaign of sanctions against Russia after its aggression of Ukraine is unprecedented in scale and scope, involving not only dozens of democratic states but also many non-state actors. It imposes considerable barriers and additional cost to the functioning of the Russian economy, which is bound to undertake deep restructuring with far-reaching consequences for production and consumption processes. The current appreciation of the rouble and inflationary slowdown are not signs of improvement but rather the direct effects of the stabilisation measures undertaken and, in fact, bode ill for further economic development. Numerous problems have started to surface this summer and optimistic assessments on the basis of initial resilience of the Russian economy look premature. Russia currently lacks a strategic plan of economic restructuring under the new environment. The future course of events will depend on whether the private sector leads this restructuring with minimal losses or the government imposes its normative prospective, tilting the result farther from economic equilibrium.

Russia | *Economy* | *Sanctions*

keywords

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1. The novelty of the Russia sanctions

The recent trend in global sanctions policy is represented by the expansion of so-called "smart sanctions", which are asymmetric in nature and more targeted than, say, the usual trade sanctions. Perhaps the Russian case in this context is different as for the first time we are not dealing with episodic and pinpointed manifestations of assorted restrictive measures, but a total sanctions war. This time, from the very beginning the initiators of sanctions – basically the United States, the European Union, the United Kingdom and a bunch of their allies in East Asia - implicitly allowed the admissibility and almost desirability of "collateral damage", that is, a downgrading of the living standards of the general population, in the target country. Moreover, they are joined in their efforts by a wide coalition consisting of private corporates, non-governmental organisations (NGOs) and individuals. The actions of this coalition are independent and not in any way controlled by government; and for instance could remain in place even if governments decide to slow or reverse their course.

Such overwhelming sanctions by design now apply to almost all Russian resident citizens and businesses, regardless of their direct or indirect involvement in the military assault on Ukraine, launched on 24 February of this year, or its origins in a wide sense of the word. It is increasingly clear that for a significant part of the representatives of the Russian elites and the middle class, this date marks a gradual but irreversible loss of the life standard to which they have become more or less accustomed in recent years. If anything can come as a surprise today, it is how stoically such a prospect is being perceived (or simply not realised so far).

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Both materially and psychologically, this loss is not the only one which matters as an effect of sanctions from the medium to long term. The "structural transformation" of the economy[1] as the Bank of Russia has elegantly termed it (or, simply put, the upcoming economic degradation under conditions of self-isolation), will certainly lead to the qualitative simplification of technologic and production processes, and a resulting plunge in systemic efficiency. The Russian economy has just recovered after the pandemic but the urgent tasks of restoration of the normal investment process and the sustainable growth of real incomes of the population are still unfulfilled. Unfortunately, instead of getting closer to normality the year 2022 has brought to the agenda the new critical challenges which exclude that these prospects may materialise any time soon.

Moreover, at the macro level the fundamental model of the Russian economy's functioning is compromised in all of its component parts. This model currently presumes massive extraction of raw materials (mostly hydrocarbon resources), their export and accumulation of reserves in the form of hard currency, which are then redistributed and spent on lacking necessities. This model is now faltering. First, on the demand side, the main direction of oil and gas deliveries to the West is already losing importance as the existing pipelines and other traditional routes of exports are blocked. Future EU embargoes threaten to further undermine this export avenue. Second, the extraction itself is to become more difficult as key technologies and partnerships are no longer available and Russia cannot effectively develop new oil and gas fields. These deficiencies will be at best only partly compensated through the so-called "parallel imports" (alternative channels of delivery of goods non-authorised by the producing foreign company). Third, the standard foreign exchange funds in the form of main reserve currencies can no longer be stored normally due to sanctions, and should be specially manipulated in order avoid an asset freeze. Fourth, the redistribution shall be also altered because of the blockade on imports, as availability of many production and consumption items is put under question. In other words, in the medium term the Russian economy will have to find alternative modes and sources for its development.

2. Is the Russian economy super-resilient?

To be fair, the short-term results of the Russian economy during the spring were not as bad as initially expected. News of foreign companies' withdrawals and interruption of the production processes due to the lack of materials and components which were previously imported (especially in car production) looked sporadic, and the majority of industries continued to operate more or less normally. The rate of unemployment in this period was, in fact, lower than a year ago. After an outburst at the beginning of the year, inflation has calmed down and allowed

[1] "Russia to Enter Structural Transformation Period in Q2, Early Q3, Says Central Bank Chief", in *TASS*, 18 April 2022, https://tass.com/economy/1439031.

the Central Bank of Russia to reverse the initial crisis hike of its key rate: from the 20 per cent level it was symbolically returned in three steps to exactly the pre-24 February level (8 per cent).[2] Along with the parallel significant strengthening of the rouble to levels unseen lately, this inspired official confidence in the limited consequences of sanctions pressure. Many experts appear to share this view.

Tellingly, most internal observers perceive the inertia of the economic system, which became apparent in the spring months, as evidence that things are not really all that scary. However, it seems that the optimistic revision of the earlier forecasts is somewhat premature. The rate of industrial interruptions will accelerate as the stocks of necessary import components run down and various bottlenecks become evident in different spheres and regions. In addition to industry, several segments in the service sectors such as advertising, movies and finance will suffer dramatic losses as well. Reduced foreign and domestic demand will sooner rather than later require adjustments in the form of job losses and wage cuts. Suppressed inflation indicates the same fall of demand along with limited monetary and fiscal expansion and renewed strengthening of the rouble.

After slowing from 17.8 per cent in April to 15.9 per cent in June,[3] annual inflation will almost certainly rebound as material shortages grow, late public sector wages and pensions indexation becomes effective (they have been since of 1 July), the federal budget experiences loss of domestic revenues and under pressure of increased military expenditures turns to a deficit, and the rouble starts falling again. The Bank of Russia, having essentially abandoned its previous policy of inflation targeting, misleads market expectations and runs the risk of coming under intense political pressure from the government when it faces the need to raise its rate again in coming months to fight inflation. Indeed, the recent rouble "renaissance" attests more to the import crunch and degradation of the balance-of-payment adjustment capabilities under sanctions and severe capital controls which were introduced by the Central Bank rather than to a fundamental strength of the Russian currency. In any event, one can hardly believe in the strong currency of a country which is, in fact, in a state of war and recently has seen half of its official foreign currency reserves frozen. Even the moderate official estimate of a fall in the real disposable incomes of Russians at 6.8 per cent[4] is an omen of future difficulties with domestic demand.

The current crisis represents an entirely new kind of shock, which is not a temporary set-back to be financed and somehow lived through but a permanent change. Its real consequences are not so easy to predict because precedents for a shock of such magnitude cannot be easily found. In other words, a smoother curve of decay

[2] Bank of Russia website: *Key Rate*, http://www.cbr.ru/eng/hd_base/keyrate.

[3] Trading Economics: *Russia Inflation Rate*, https://tradingeconomics.com/russia/inflation-cpi.

[4] "Russia Forecasts 7.8% GDP Contraction in 2022; Unemployment Rate at 6.7%", in *Business Standard*, 18 May 2022, https://www.business-standard.com/article/international/russia-forecasts-7-8-gdp-contraction-in-2022-unemployment-rate-at-6-7-122051800198_1.html.

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is not at all tantamount to reducing its quantitative depth and, most importantly, qualitative substance. It is not a secret that "complex" industries requiring a lot of foreign components and technologies will be hurt the most, damaging national competencies and the human capital involved. The short-term resilience of the Russian economy probably should not surprise anyone also because, in spite of rapid expansion of the state in the recent years, Russia has preserved significant segments of the competitive market environment and smart private sector managers who can work effectively in stressful situations.

3. Government policy matters

Of course, the mode of the Russian government's reaction to sanctions is currently very important. When the economy misfunctions, a lot depends on the public policies adopted to promote resilience and economic restructuring. In reality, so far no signs indicate that a profound policy change is taking place. On the contrary, continuation of key policies from before the crisis, such as the "budget rule",[5] is being promoted even though the situation has changed dramatically, and orderly execution of the budget according to fixed rules and accumulation of the dollar – and euro – denominated National Wealth Fund is hardly possible any longer. Import substitution in its extreme form and resetting the trade and logistics infrastructure towards Asia and China are also set as top priorities, but no major corresponding project has been announced or financed yet. Public officials seem to hope that the problems will somehow fix by themselves, and no urgent action will be necessary.

This stalemate is partly due to the fact that the current policymaking process is inherently polycentric and extremely complex from a managerial point of view. This process should involve strong coordination efforts and an imposition of discipline on a large number of officials and public corporates' managers, who usually do not experience competitive pressure to perform and have not got used to taking on serious personal responsibility (actually their usual incentives were exactly the opposite – just to wait for direct and unambiguous instructions). This is in fact probably the main challenge for the government in the coming period.

4. Two scenarios

Theoretically, two extreme scenarios of future Russia's economic transformation are possible. The first is relatively spontaneous, as the economy – and above all its private sector – adapts to the new physical and price parameters environment,

[5] Set of formulas according to which the budget is being formed and executed – the limit of expenditures, deficit financing, accumulation of the oil and gas revenues, their conversion into hard currency, etc.

resulting in a new (and relatively worsened) state of equilibrium. The main characteristics of such an equilibrium are still unclear, but production (and managerial) factors in it should be combined differently. Complexity will be rejected by such an economy, so that a significant part of the best factors of production (including qualified labour) will remain unused, which probably is the main problem of the new equilibrium from a political and economic point of view. Of course, this scenario in its extreme form is unrealistic as the forces of inertia and political influence will prevent more or less free redistribution of resources in the economy to an ideal equilibrium from the market point of view.

Therefore, it is worth analysing the second scenario of transformation, which is built for the most part not on market signals, but on the basis of a largely conservative normative prospective dictated by the ideology of the ruling elites. As they broadly speaking consider themselves at war, and the outside world (with rare exceptions) is represented as outright or potential enemies, the economic policy – from corporate governance to capital regulations – will also reflect this view. For instance, publication of several items of standard economic statistics (e.g., foreign trade and federal budget) has already been stopped to conceal the real state of the economy.

The ruling elites are increasingly ready to give up market economy mechanisms to pursue their priorities by relatively simple administrative means; for instance, public procedures of procurement are no longer applicable in many spheres. According to this view, re-allocation of resources to achieve strategic purposes can be provided not only from public coffers or with the help of positive policy incentives, but also by direct orders in the course of outright military-oriented mobilisation of the economy. On the contrary, market-based solutions will be allowed only to a limited extent, provided that they do not contradict state prescriptions. The second scenario in its full-fledged form is certainly also unattainable. The future reality seems to lie somewhere in between the two scenarios, but it is likely to be much closer to the second one rather than to a purely market equilibrium.

In the longer run, the success of the transformation and the economic efficiency of such transformation will depend on the amount of resources mobilised in a non-market way, and what limitations on market-oriented behaviour are introduced by the government (for example, bans on a free release of unemployed labour[6]). It also remains to be seen whether alternative sources for certain supplies (technologies, equipment, components), such as China, could be reliable, as Russia is a second mover in a sanctions game. Initial indications show that so far the Chinese authorities and businesses are quite cautious in replacing Western sources of materials and technologies to avoid the extra-territorial reach of US secondary sanctions as well as other potential measures by the US and EU to retaliate against any attempt at softening the impact of their own restrictions on Russia. In turn,

[6] Usually private enterprises under the pressure from the federal or regional government cannot freely dispose the redundant labour force which might remain formally employed.

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the majority of Russian corporations are not yet accustomed to working with the Asian markets and will need time for re-orientation and accumulation of expertise.

Conclusion

The Russian economy faces enormous challenges in the forthcoming months. Its trajectory will depend on how successfully the transformation process is managed at the micro level by the corporations and at the macro level by the government. Market incentives will play at best a limited role in this process, and political considerations and sanctions uncertainties will prevail. In the meantime, economic degradation and overall loss of efficiency are imminent and can be prevented only to a minor extent. The future model of the Russian economy's functioning is unclear and its prospective competitive advantages have yet to be determined.

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