

The Russian embargo is affecting Russia

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On 7 August, pursuant to President Vladimir Putin's decree of 6 August the Russian government imposed an annual ban on the import of selected groups of agricultural and food products from countries which had previously imposed economic sanctions on Russian citizens and companies which have joined in such sanctions. The ban extends to imports from EU countries, the USA, Canada, Australia and Norway (it has not affected Japan and Switzerland although they also joined in the sanctions against Russia).

The embargo was intended to serve as an act of retaliation in response to Western sanctions, but it will strongly affect the Russian economy which is greatly dependent on imports of food and agricultural products. Most of the government's attempts to replace previous imports from the EU with domestic production and imports from new, geographically more distant suppliers will be unsuccessful and may lead to dissatisfaction among the Russian public who will have to pay the cost of the political decisions.

The goal of the Russian sanctions

The Kremlin's decision to impose the sanctions on exporters from EU member states was made as an immediate reaction to the EU sanctions imposed on 1 August. It was taken very hastily under pressure from President Vladimir Putin, whose primary goal was to deal a rapid blow to the producers and also to mobilise the opponents of sanctions inside the EU.

Putin's moves have been successful to a certain extent. One proof of this is the stance taken by some politicians from EU member states, who have criticised the sanctions imposed by the RF and/or have made attempts to alleviate them due to the negative consequences for their economies (to name a few: the Hungarian prime minister Viktor Orban, the Slovakian prime minister Robert Fico, the president of the Czech Republic *Milos Zeman* and the president of Finland *Sauli Niinisto*).

The list of sanctions was developed by ministerial staff, without consulting producers and importers. For this reason no exclusions were made for goods which are not produced in Russia and which are necessary for patients suffering from diabetes and food allergies and for athletes (85% of these goods are imported from the USA and Germany), and also for farmers (seed potatoes) and fish farmers (salmon alevin). It has therefore been announced that this list needs to be adjusted.

Furthermore, to discourage the EU from imposing a new package of sanctions – as has been heralded – Prime Minister Dmitry Medvedev has threatened that Russia is ready to announce an embargo on industrial goods in retaliation, which would include cars and

medical equipment; these have a significant share in EU exports to Russia. In turn, the Russian minister of foreign affairs, Sergey Lavrov, has suggested that air traffic over Siberia for passenger planes flying from Europe to Asia could be banned.

The impact of the Russian sanctions on the domestic market

Russia has for years been a major importer of food and agricultural products and raw materials. In 2013, these imports were worth US\$43 billion, i.e. 13.6% of total imports. Russia is most heavily dependent on supplies of beef (according to some estimates, up to 62% of consumption), fish (50%), cheese and curd (48%) and fruit (45%).

The sanctions also extend to one of the most sensitive segments of Russian imports from the EU, in which the value of total supplies of goods affected by the embargo reaches US\$16 billion annually. Russia's share in EU exports of food and agricultural products (outside the EU) in 2013 stood at 14%. For example, EU countries account for 87% of Russia's cheese imports. They also have a high share in Russian imports of dairy products (42%), beef (31%), processed meat (37%) and fruit (32%). The embargo has had the strongest impact on Finland, Lithuania, Latvia and Estonia—between 20–30% of their exports of food and agricultural products (mostly dairy products) are sold to Russia. The sanctions are also painful to Norwegian producers, who used to sell 11% of their fish (mainly salmon) production to Russia. Poland has been affected most strongly by the embargo on its apples, over 60% of which are exported to Russia. Thousands of exporters as well as Russian buyers and food-processing companies will sustain substantial losses as a consequence of the embargo imposed by the Russian government on meat and meat products, fish, shellfish, fruit and vegetables, milk and dairy products and vegetable oil foods.

The sudden termination of contracts with suppliers without any transition period has disrupted supplies to the Russian domestic market and the previous logistics of supplies. Dozens of trucks and ships carrying goods –and in many cases these have already been paid for – are stuck at border checkpoints and in ports. As imported products began to disappear from the shelves, prices for them began to rise with equal rapidity. The prices of dairy products and fish went up between 5% and 6% in the past week alone. Retail meat prices have increased by between 10% and 22%, and the prices of some meat products by as much as 40%. Prices are set to continue to grow in the coming weeks, and no controls or governmental orders or bans will be able to stop this process.

The unsuccessful attempts to alleviate the consequences of the sanctions

The Russian government has taken action accompanied by a media campaign which aims to downplay the negative impact of the sanctions on internal market supplies and to convince the public that Russia is ready to substitute imports with domestic production and to replace selected missing goods with imports from countries on which sanctions have not been imposed (Latin America, Turkey, Egypt, Morocco, China, Uzbekistan, Turkmenistan and Azerbaijan). Furthermore, the government has declared that potential shortages in goods will be compensated with state reserves. The government has also taken numerous administrative measures to counteract the rise in prices on the domestic market.

The government's actions appear to have been rather unsuccessful, and even have proven that the government is not familiar with market reality and the problems the Russian economy is facing.

Domestic producers will be able to stand in for the previous foreign suppliers only to a small extent in the coming months. **Domestic production** in the case of many product groups is uncompetitive in terms of price and quality when compared to imported goods. Many of the products on which the sanctions have been imposed (selected varieties of cheese, fish, fruit and many others) are not produced or processed in Russia at all. The development of land cultivation, animal husbandry and gardening have been neglected for years and so this along with the reconstruction of food and agricultural production processing plants (slaughterhouses, warehouses, cold stores, sorting plants, etc.) will require a few years, vast financial outlays and the preparation of qualified staff at the very least. The development of agricultural production must also be accompanied by the development of agricultural machinery production and services, the reconstruction of research and development centres dedicated to agriculture, the development of veterinary and epidemiological services and many other measures. Russia, which has adopted restrictive sanitary and epidemiological requirements with regard to foreign suppliers (the ban on imports of pork from EU countries due to the African swine fever virus), has not been able to cope with the problem of animal diseases at home. 106 cases of African swine fever virus have been registered in Russian regions, including 56 new cases in 2014. Most of the programmes which have thus far been adopted to boost agricultural production funded from the state budget have failed to bring the expected results. A great part of the funds has been wasted, stolen or transferred abroad by large manufacturers registered in tax havens. Given the difficult situation the Russian economy has found itself in and the Western sanctions, no increase in investments in the agricultural sector should realistically be expected. The Russian regions are plunged in debt and have no funds to boost the development of agricultural production. Furthermore, Russian firms will find it much more difficult and expensive to gain access to foreign loans due to the sanctions currently in force. Furthermore those Russian firms operating in the food and agricultural sector which would be ready to make new investments backed by government loans fear that their production will be uncompetitive and that they will fail to find buyers once the sanctions are lifted.

The Russian government has also taken **action to replace EU imports** with supplies from Brazil and other Latin American countries, and also from Egypt, Turkey, Iran, China and many other countries. To a large extent, these moves will also be unsuccessful. Goods coming from such distant sources will in many cases be more expensive, for example, due to transport costs. Furthermore, many producers will be aware of the lack of competition and will make attempts to raise their prices. According to data from the Association of the Meat Industry, the prices of meat supplied from Brazil will go up between 20% and 30% starting from September. In addition to this, many foreign producers are withholding their supplies because they are waiting for the prices to increase further. Another problem –yet to be mentioned by representatives of the Russian government – is the safety of food supplies from the new sources and their compliance with Russian sanitary and veterinary standards; and these issues were often discussed and disputed with Western suppliers. The Russian Federal Service for Veterinary and Phytosanitary Surveillance (Rosselkhoz nadzor) will be

unable to inspect hundreds of new plants in such a short time. Supplies can therefore only be made on the basis of guarantees from the national veterinary services of the exporters.

The Kremlin is aware of the mounting problems with domestic market supplies, and will be forced to **tolerate direct or indirect re-exports** of products covered by the sanctions via Belarus and (to a lesser extent) Kazakhstan, which have refused to join in the Russian sanctions. The decisions taken by Belarus and Kazakhstan are proof that the Customs Union and the Common Economic Space lack a common trade policy, and they are not a good portent for the planned transition to the next stage of the integration process starting from 2015, namely the Eurasian Economic Union. Belarus, which has been struggling with economic problems for years, hopes to earn extra income on the significant increase in exports of products covered by the sanctions to Russia; this includes both its own domestic output and processed food and also agricultural products from EU countries.

Forecast

The Kremlin imposed the sanctions on food and agricultural products from EU member states without giving the decision more careful consideration concerning the possible adverse impact they might have on the Russian economy. The consequence of these hasty decisions will be GDP falling at a faster rate, the inflation rate rising and more capital flowing out of Russia. The sanctions will also contribute to a deterioration of the purchasing power of Russian society due to the increase in prices; and this will translate into lower public support for the government's actions.

It appears that both Russia and the EU member states, for which the Russian sanctions are very painful, will search for compromise solutions in the coming months to prevent a further escalation of the sanctions. However, economic co-operation is very unlikely to be brought back to previous levels within this timeframe.