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The economic consequences of the war: a profound crisis looming for Russia

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In retaliation for its military aggression against Ukraine Russia has been sanctioned by around 50 countries, which accounted for half of Russia's foreign trade and were of key importance to the stability of its capital market. The sanctions have hit the foundations of the Russian economy, principally targeting the financial market. The measures have affected every single sector of the economy, and the negative consequences of most of these measures have been immediate. Undoubtedly, this came as a major surprise to the Kremlin, especially as the scale of the sanctions considerably exceeded the scale of possible restrictions hinted at ahead of the invasion. It can be expected that as long as Russia continues to attack Ukraine, further restrictions will be imposed on it, including on its raw material sector.

The authorities in Moscow had been preparing for severe sanctions for years: they had amassed financial reserves and reduced Russia's dependence on imports. This was done at the expense of the Russian population, which became increasingly impoverished as a result. However, when deciding to invade Ukraine, the Kremlin underestimated the West's determination and its own dependence on foreign supplies. As a consequence, the first three weeks of the war alone have shaken Russia's financial stability. Therefore, instead of economic growth at a level of 2%, in 2022 Russia will likely face a recession involving an economic decline of around 10–20%. In spite of this profound crisis, however, the Russian economy will not collapse completely. Despite the need to reduce the country's exports, the raw material sector, which is the main source of Russia's revenue, is benefiting particularly from high prices, especially the prices of oil, gas, coal and metals. At this point, it is impossible to assess the magnitude of the crisis. Russia will most likely be affected by a recession lasting several years. The role of the state in the economy will increase, economic cooperation with foreign partners (most notably with the West) will be limited, while China's role in economic cooperation will rise. Alongside this, the degradation of the country's technological infrastructure will continue.

Massive sanctions against Russia

The main blow the West has dealt to the Russian economy involved cutting the Kremlin off from most of its accumulated foreign currency reserves, totalling more than US$640 billion, which had been held in accounts in Western banks: around 50% of these reserves have been frozen. Russia keeps another 20% of its reserves in gold, which at present is difficult to convert into foreign currencies.

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The sanctions also covered a portion of the Russian government's reserves in Western securities and currencies kept by the National Wealth Fund (NWF), which are held in accounts run by the Central Bank of Russia (CBR). Around half of the fund's liquid assets, or around US$55 billion, were held in Western currencies, and another 20% in gold (as of 1 February 2022, the NWF's liquid assets amounted to around US$112 billion: this sum includes €38.6 billion, £4.2 billion, 600 billion yen, 226.7 billion renminbi, 405.7 tonnes of gold, and 226 million roubles).

In addition, severe restrictions (including a ban on effecting transactions in US dollars) were imposed on several major state-controlled banks.[1] Another restriction involved banning Western lenders from lending capital to the Russian government and to many of Russia's largest, mainly state-controlled companies.[2] In another package of sanctions, several Russian banks were disconnected from the SWIFT interbank telecommunication system,[3] and Visa and Mastercard cards issued by Russian banks stopped being serviced outside Russia.

Massive sanctions have hit the Russian economy hard; these include cutting the Kremlin off from its foreign currency reserves, alongside a series of other import and export restrictions.

Another measure of key importance to many sectors of the Russian economy (e.g. arms, aviation, space, energy sectors) involved introducing an embargo on the export to Russia of high-technology goods and services, including 'sensitive' technologies such as chips and semiconductors. Western states have also closed their airspace to Russian carriers, and introduced an embargo on the supply of spare parts and the provision of services (including lease services) to Russian companies. As a consequence, the aircraft's owners (mainly companies incorporated in Ireland and Singapore) began to demand the return of their planes. In addition, the Civil Aviation Authority of Bermuda (a British Overseas Territory) decided to suspend the certification of aircraft used by Russian carriers which had been registered in Bermuda. Almost 750 planes leased by Russian carriers are registered there, accounting for around half of Russia's passenger fleet. They are no longer allowed to fly without a valid certificate.

Western restrictions have also affected Russian exports. The US has suspended imports of Russian fuels: oil, petroleum products, liquefied gas, coal and coal products. Similarly, the UK has suspended its purchases of Russian oil and raised its import tariffs (by 35%) on numerous other goods, including ferrous and non-ferrous metals, fertilisers and timber. The EU, for its part, has suspended its import of certain iron and steel products from Russia.

Alongside this, the West has targeted the Kremlin elite and their family members. Over 1000 individuals have been put on sanction lists and their foreign assets (villas, yachts, planes, bank accounts etc.), whose worth is estimated at hundreds of billions of dollars, have been frozen. These individuals have also been banned from entering Western states.

Aside from the official sanctions imposed by Western governments, an equally strong blow to the Russian economy has come from a wave of restrictions introduced directly by multinational companies, as well as sports, cultural and scientific organisations. Citing concerns about their reputations, these organisations have begun to sever their cooperation with Russia, to halt their production activities and to cease to supply goods, technologies and services to Russia. Companies that have withdrawn

1 I. Wiśniewska, 'Nowe zachodnie sankcje przeciwko Rosji', OSW, 25 February 2022, osw.waw.pl.
2 *Ead.*, 'Zachodnie sankcje i ich konsekwencje', OSW, 24 February 2022, osw.waw.pl.
3 Council Decision (CFSP) 2022/346 of 1 March 2022 amending Decision 2014/512/CFSP concerning restrictive measures in view of Russia's actions destabilising the situation in Ukraine, *Official Journal of the European Union* L 63, 2 March 2022, eur-lex.europa.eu.

from Russia include BP, Shell, Siemens, Nokia and Ericsson; the McDonald's fast food chain, alongside other similar businesses, has closed its restaurants in Russia. Some Western customers have also stopped importing Russian commodities, including oil, petroleum products and cereals.

The Kremlin's reactions to the sanctions

The Central Bank of Russia was the first to react to the massive sanctions: it focused on fighting inflation (it raised the base interest rate from 9.5% to 20%) as well as on maintaining the liquidity of the banking sector. To achieve this, it introduced a mechanism to control currency flows to keep foreign currencies within Russia, particularly in the financial sector. It announced limits on foreign currency transfers and on exports of cash. The access of natural persons and businesses to foreign currencies in cash has been severely restricted.[4] In addition, exporters have been obliged to resell 80% of their foreign currency revenue on the domestic market in an attempt to sustain the supply of foreign currencies, and at the same time to curb the continued devaluation of the rouble. Moreover, a temporary ban has been introduced on offering (foreign currency) loans to foreign businesses and on Russian citizens and Russian companies purchasing stakes in foreign businesses without the CBR's approval.

> **As part of protective measures, the Russian government has introduced instruments to regulate the domestic market, thereby significantly limiting the freedom of doing business.**

At the same time, the Kremlin has allowed Russian borrowers to temporarily use roubles to repay their foreign currency liabilities to creditors from states that have imposed sanctions on Russia.[5] These sums are to be transferred to accounts run by Russian banks. Despite these restrictions, some of Russia's largest exporters, including Gazprom, Rosneft, Norilsk Nickel, Russian Railways and Severstal, have received special authorisations from the Ministry of Finance to repay their liabilities using foreign currencies. On 16 March 2022, this Ministry effected its dollar bond payments. Earlier, two Russian companies, Gazprom and Rosneft, redeemed their bonds for dollars.

Due to a massive outflow of investors, on 28 February 2022 the CBR suspended trading on the Moscow Stock Exchange (which was only resumed on 21 March 2022, albeit partially). Alongside this, the Ministry of Finance announced that it would earmark 1 trillion roubles (around U$S9 billion) for the purchase of stakes in domestic companies. In addition, Russian issuers were allowed to redeem their own shares.

The government is also seeking to convince companies that have suspended their cooperation with Russia as part of the boycott provoked by its aggression against Ukraine to resume their operations. It has banned the export of foodstuffs and medicines, as well as machines, devices and means of transport brought to Russia by Western companies. This means that the multinationals have de facto been prevented from withdrawing a portion of their movable assets from Russia. Although the Kremlin has begun to issue threats regarding the possible nationalisation of these companies' Russian assets, so far this has not happened. Increasingly frequently suggestions are being voiced that these companies should be put into receivership (which would be a lighter version of nationalisation and would not explicitly be called as such). In each such company, a team of receivers would attempt to resume production provided that substitute components and subassemblies can be obtained from alternative suppliers.

In order to stabilise the situation on the domestic market, the Russian government has decided to limit the export of grains and sugar. For example, it has instructed the regional authorities to offer assistance to citizens who are in a particularly difficult financial situation, to monitor the prices of basic necessities

[4] I. Wiśniewska, 'Gospodarka Rosji: deficyt dewiz', OSW, 9 March 2022, osw.waw.pl.
[5] *Ead.*, 'Sanctions against Russia: the government is becoming increasingly nervous', OSW, 7 March 2022, osw.waw.pl.

(foodstuffs, hygiene products and medicines), to take steps to reduce demand for certain types of goods and services, and to support Russian businesses by offering them additional funds, tax reliefs and preferences. However, so far the Kremlin has not decided to offer additional financial assistance to Russia's regions. It has only promised to index-link the transfers already planned to inflation, to provide relief on repayments of existing loans, and to launch new lines of credit. The government has also announced salary raises for state sector employees, pension rises, and an increase in the subsistence level.

The government has devised an action plan to stabilise the economy. At present, this includes more than 100 initiatives worth a total of around 1 trillion roubles (around US$9 billion). These initiatives are expected to contribute to the reorganisation of cooperation and logistics chains nationwide, and to the creation of mechanisms to supply of goods and services to businesses and consumers from alternative new suppliers. The hope is for all this to be achieved, for example, through tariff liberalisation, preferential loans offered to businesses (especially in the agriculture and energy sectors), and down-payments (50–80%) for the implementation of projects financed under public procurement.[6]

The first effects of the sanctions

The effects of the sanctions started to become apparent in Russia in the first days of the war. Initially, the financial market suffered the most, as investors began to sell off stakes in Russian companies and citizens withdrew their money, especially foreign currency deposits, from the banks. During the first week of the invasion, the dollar rose by 100% against the rouble. The exchange rate reached 150 roubles to the dollar (compared to around 78 roubles to the dollar before the war). However, the situation stabilised as a result of the restrictions introduced the CBR, which involved sustaining the supply of foreign currencies (by imposing the requirement on exporters to resell 80% of their foreign currency earnings) and reducing the demand for them (by regulating access to foreign currency deposits and banning the purchase of cash). By the second half of March 2022, the official exchange rate had been kept below 110 roubles for one dollar. However, the restrictions on access to foreign currencies have revived the 'black market'. In social networks, many users are seeking opportunities to buy US dollars at unofficial exchange rates of up to 200 roubles to the dollar.

> **So far, the government's actions have stabilised the rouble's exchange rate. However, the rate of inflation continues to rise dynamically.**

The Russian government's actions aimed at combating price increases have been much less effective so far. According to Rosstat, on 11 March 2022 the annual inflation rate was 12.5%. In the first two weeks of the war, prices rose by more than 2% weekly (the highest increase since 1998). In the first half of March (compared to the end of February), the prices of imported goods rose the most: tomatoes and bananas by around 17%, TV sets by more than 20%, passenger cars by 15%, and medicines by around 10%. However, the actual inflation rate affecting various social groups and businesses may be much higher (depending on the goods they buy). The high prices result on the one hand from the fact that new batches of increasingly expensive imported goods have entered the Russian market, and on the other from increased demand (Russians are trying to protect their finances against inflation by buying more goods) together with a reduced supply of goods.

In the transport sector, aviation has been most affected by the sanctions. Restrictions regarding specific flight destinations and the fear that leased aircraft may be confiscated at foreign airports have resulted in flights abroad, mainly by major carriers such as Aeroflot and S7, being temporarily suspended. In mid-March 2022, some flights were resumed, although they were served by Russian-owned aircraft, in particular the Sukhoi Superjet (which can carry up to 95 passengers onboard).

[6] *Ead.*, 'Zachód i Rosja: niesymetryczne ciosy sankcyjne', OSW, 16 March 2022, osw.waw.pl.

Even before the war, this Russian-manufactured aircraft had suffered from serious technical problems and a shortage of spare parts. The domestic market, for its part, is currently served mainly by leased aircraft, including some that do not have valid airworthiness certificates. The Russian authorities have started to add the Bermuda-registered aircraft to the Russian register and to issue alternative, Russian airworthiness certificates to them. However, in the coming weeks air travel within Russia will become risky due to the shortage of spare parts preventing the necessary repair and maintenance activities. Another problem significantly affecting the aviation sector involves the drop in demand for tourism services, which in turn has triggered a rise in the cost of foreign travel. The average price of a holiday trip to Turkey has gone up by almost 50%.

As regards Russia's industrial sector, the automotive branch has been most affected. Domestic car production has largely stopped due to the lack of subassemblies and the withdrawal of foreign investors. In addition, there have been disruptions to supplies of imported Western cars and automotive parts.

The service sector is another branch of the economy that has lost a significant portion of its revenue, with restaurants, beauty parlours and fitness clubs being particularly affected by the decline. Aware of the imminent crisis, Russians have begun to make savings and decided to cancel many of their expenses. Small and medium-sized businesses, which have not yet managed to recover from the pandemic-related decline, are particularly affected by the present difficulties, which may finish many of them off. Most of these companies are still trying to repay their previous loans.

Russian exports, including oil, metals, grains and fertilisers, have also been affected by the restrictions, both those imposed by the Western states and those introduced unilaterally by individual foreign partners. The oil sector, which is the main source of Russia's state budget revenue, is experiencing the most serious problems. In mid-March 2022, Russian oil exports fell by more than 30%, i.e. by 2.5 million barrels daily (with crude oil accounting for 1.5 million barrels and petroleum products for 1 million barrels). As a consequence, Russian Urals oil is being sold at a much lower price (on average US$30–35 per barrel lower) than Brent oil, which on 19 March 2022 cost around US$110 per barrel. At the same time, the freight prices of Russian oil and the cost of insuring it have increased several-fold.

> **At present, the high oil prices are the main factor enabling Russia to obtain foreign currencies, which is greatly helping the Kremlin to combat the consequences of the sanctions.**

According to estimates by the Ministry of Finance from 3 March 2022, in February 2022 the state budget earned an additional 570 billion roubles (around US$7 billion, calculated using the pre-war exchange rate) generated by the oil and gas sector as a result of the higher than expected prices of these commodities. This sum will be kept in the state budget, as the rule according to which any oil and gas budget surplus should be converted into gold and foreign currencies has temporarily been suspended. Although at present the price of Russian oil is much higher than the Urals oil benchmark price assumed in the budget (i.e. US$44.2 per barrel), the rouble's exchange rate is around 30% lower than it was before the war (Russia receives its oil revenue in dollars, but this sum is converted into roubles before it is transferred to the state budget) and the inflation rate is higher. At the same time, there has been a major decline in Russia's oil and petroleum product exports. As a result, the exchange rate fluctuations and the increase in prices may compensate for the financial losses resulting from declining exports.[7]

[7] In 2021, Russia's budget revenue from the sale of oil and gas amounted to around US$125 billion, and accounted for 36% of the federal budget and around 18% of the consolidated budget (i.e. the federal budget combined with the regional budgets). Because the average annual price of Urals oil was US$69 per barrel, this revenue was more than US$40 billion higher than initially planned in the budget assumptions (in which the assumed price was US$44 per barrel).

The problems with access to foreign currencies has resulted in Russia's credit ratings being downgraded by all the major agencies to a level suggesting that sovereign default is imminent. However, for the time being, both the Russian state and Russian companies are still meeting their obligations. In particular large exporters with foreign currency earnings are making efforts to avoid a (technical) default, as this would only aggravate their problems (it would have specific legal consequences, and would encourage other investors to demand early repayment of the remainder of the debt). Russian big business is fully aware of the magnitude of the economic problems the country is currently facing, and estimates the losses it has already incurred at billions of dollars. Although most of its representatives are against the war, only a few of them have openly expressed their opinion in public (Oleg Deripaska, Mikhail Fridman, Vladimir Lisin) in an attempt not to sever their cooperation with the West completely. However, all of them are dependent on the Kremlin, and could be stripped of their assets in Russia at any time. The Russian authorities have sufficient instruments to enforce such a decision if necessary.

Within the first few weeks following the introduction of the sanctions, many sectors of the Russian economy (in particular the financial service sector) have regressed to earlier stages of their development in terms of technological advancement. In this context, it should be noted that the degree of digitalisation in Russia's big cities was very high, especially in public administration and in the service sector. Therefore, the present situation represents just the beginning of degradation of Russia's technological infrastructure.

Outlook

The present crisis into which Russia is increasingly plunging differs considerably from the five previous crises the country has experienced over the last 30 years (in the early 1990s, 1998, 2008/9, 2014/15, 2020). In these past crises, the recessions were triggered by a decline in oil prices, which affected the economy as a whole. In contrast, the causes of the present crisis are political. Although commodity prices are rising dynamically, Russia is gradually being cut off from its export markets and specific imports. For this reason, it will be extremely difficult to combat this crisis using economic instruments. Russia will most likely experience a recession lasting several years, and efforts to restore its pre-war level of development may take a decade, because it will be very difficult to identify any potential economic growth factors in this new reality.

> **The use of economic instruments to fight the crisis, whose underlying causes are political, is proving moderately effective.**

Because new sanctions are still being imposed and the economy is experiencing further shocks, it is not possible to assess the true scale of the crisis. Most of the recently published forecasts (such as the forecast compiled by the Allianz insurance company) suggest a decline in GDP of around 10% in 2022; several even more pessimistic forecasts (such as the forecast prepared by the Institute of International Finance) suggest that the Russian economy may shrink by more than 15%. At the same time, the inflation rate is expected to exceed 20%. This will equate to a significant decline in Russian society's income, but the actual magnitude of this decline will depend on what actions the government takes.

The Kremlin is mainly hoping to maintain a steady flow of foreign currency revenues from its raw material exports. At this point it is difficult to come up with a comprehensive assessment of Russia's 2022 budget as a whole. According to the latest forecast by the International Energy Agency (IEA), as of April 2022 Russia's oil production may decline by 3 million barrels daily, i.e. by almost 30%

(in February 2022, production was 11.1 million barrels daily).[8] Alongside this, global oil prices will continue to rise, which will partly compensate for Russia's losses resulting from the fall in exports. However, other budget revenues, including those generated by the industrial and the service sectors and by Russia's regions, will likely decrease, while budget expenditures will increase. The government has announced various support measures targeted at businesses (mainly intended to keep people employed), as well as at the poorest members of society and public sector employees, in an attempt to prevent the emergence of nationwide discontent over economic difficulties.

It is likely that some regions (especially those that do not have significant raw material resources) will demand that the authorities increase the financial transfers offered to them, especially as local administrations are responsible for providing citizens with social assistance. In addition, at this point it is not known how long the hostilities will last and what their cost will be. As a consequence, some of the government's previously planned investment projects will likely have to be abandoned. The Russian government has already hinted that some of the expenditures connected with the implementation of several nationwide projects (focusing on health care, ecology and infrastructure) will need to be postponed. When it comes to expenditures denominated in roubles, the Kremlin is capable of increasing its money printing activity but this, in turn, would increase the rate of inflation further, creating a burden which the government would need to shoulder.

However, the Russian economy will not collapse completely. The importance of two particular sectors will increase: the agri-food sector and the raw material sector. The role of the former will be to supply food to Russian citizens, thereby preventing a situation in which food shortages could lead to increased social discontent. Even before the war, Russia was able to meet its demand for cereals, fish and poultry meat. However, it is still dependent on imports of milk, fruit and vegetables. In the present situation, judging by the previous crises, it can be expected that growing vegetables in home and country gardens will become increasingly popular.

The role of the raw material sector will be to provide Russia with foreign currency revenue enabling it to import essential goods such as agri-food products and medicines, as well as consumer goods. The raw material sector continues to sell its goods to foreign customers, but if the war continues, the Western demand for this sector's commodities is expected to decline even further. If Russia ends up having to reduce production in its oil and gas sectors, this could have long-term consequences. In particular, the process of reactivating many West Siberian oil and gas fields (which form Russia's production base) – should they need to be shut down – will take a long time and require considerable funds. The emergency solution could be to flare resources immediately at the oil and gas wells. However, this could trigger environmental disasters.

Without political changes in the Kremlin, it can be expected that the current political and economic model will continue to solidify in the short term. The role of the state in Russia's economy will increase, including plans to invest a portion of the funds managed by the National Wealth Fund in shares issued by domestic companies, and to put companies owned by those Western corporations which have suspended their operations in Russia into receivership. In addition, due to the increasingly totalitarian tendencies of the Putin regime,[9] it should be expected that the FSB will step up control of business, including attempts to force big privately-owned companies to become more involved in financing social spending and implementing policies endorsed by the state. Because the state budget will play a key part in redistributing resources from the raw material sector

[8] N. Browning, 'IEA says market may lose 3 mln bpd of Russian oil next month', Reuters, 16 March 2022, reuters.com.

[9] M. Domańska, K. Chawryło, 'War dictatorship: power and society in Russia', *OSW Commentary*, no. 433, 22 March 2022, osw.waw.pl.

to other industries, corruption will also increase. It is likely that access to state-controlled resources, which are already shrinking significantly, will mainly be offered to the Kremlin's closest political and business allies.

Moreover, we should expect Russia to continue its self-isolation from the world, in line with the policy that the Kremlin has pursued over recent years. Foreign cooperation (in particular with the West) will be reduced to a minimum, and the importance of China in Russia's eyes will likely increase. Should Moscow gain access to capital offered by foreign lenders, especially in the context of investments in the raw material sector, it will likely be forced to make Russian oil and gas fields available to those investors, to secure these loans with supplies of raw materials, and to consent to the investors using Russian armaments technologies. This form of cooperation has been Beijing's preferred model in its investment relations with Russia for several years now. However, it is unlikely that China would be prepared to supply Russia with technologies and spare parts (e.g. to service aircraft) banned by the West, because it would risk being covered by US secondary restrictions for failing to comply with the sanctions imposed on Russia. Furthermore, China is also still heavily dependent on US technology in many sectors (e.g. electronics and aviation). As a consequence, the sanctions that are already in place will lead to the gradual degradation of Russia's existing technological infrastructure.