

The impact of sanctions on Russia: Negligible now, disastrous later

The Russian economy can for the time being absorb the twin shocks of sanctions and reduced energy earnings, writes **Evsey Gurvich**. But in the longer term, isolation from technology transfers will have crippling effects

Russia's economy had really hard times in late 2014 and early 2015. Falling oil prices since late 2014 have more than halved the value of Russia's oil exports, and nobody can say how long this trend will continue. The rouble's exchange rate against the U.S. dollar doubled to 70 roubles in February from 33 roubles a year earlier. This exchange rate volatility is encouraging Russia's demand for hard currency and is undermining the country's economic activity.

Sharp increases in the prices of imported goods have led to explosive inflation in Russia; January saw consumer prices rise by almost 4% in just a single month at the moment the Central Bank was announcing a medium-term annual inflation target of 4%. Year on year inflation now stands at almost 17%, with the result that real wages have declined by almost 10%. To restrain prices, the Bank of Russia raised its key interest rate to 17% in December 2014, but the effect was that the banking and corporate sectors were in shock because they feared that the new interest rate could make the cost of domestic borrowing prohibitive and thus hamper lending.

This difficult situation has been greatly aggravated by the financial sanctions being imposed on Russia. Most of the world's advanced countries have introduced strict barriers on access by major Russian banks and companies to their capital markets. The effects of this have proven even more damaging than originally expected, as the contagion of these sanctions has spread also to other domestic borrowers in Russia. The overall position is that the ability of Russian businesses to borrow internationally – even just to refinance maturing debt – has now roughly halved. An additional



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blow was delivered when two of the international rating agencies downgraded Russia to non-investment range, further limiting the country's foreign borrowing potential. Investment has dropped sharply and the Russian economy has lost an important potential source of demand growth.

Against this background, it's small wonder that for several months the economic situation in Russia has looked increasingly sinister, with forecasts getting worse and worse thanks to growing uncertainty and increasing risk.

When the decline in oil prices stopped, the Russian economy stabilised and there were welcome but unexpected improvements in the near-term projections of both domestic and international experts. The most impressive changes occurred in the Forex market, where the exchange rate trend reversed and the rouble gained around half of its previous loss against the dollar. This seemed to reflect two facts, first that there had been an overshooting in the rouble's depreciation, and second that a crucial change has taken place in investors' expectations.

So how should one judge the overall impact on the Russian economy of lower oil prices and the international sanctions? Most forecasts are predicting that Russia's GDP will shrink by 3-3.5% in 2015, with the substantial decreases in consumer demand and investment being partly offset by declining imports. The losses Russia will suffer in terms of production and people's standards of living are certain to be substantial – the anticipated drop in real wages of up to 10% may be the greatest suffered by Russians since the beginning of the 21st Century. It is also worth mentioning that rises in food prices – partly attributed to 'counter-sanctions' that have barred imported foodstuffs – are at a record high. This has primarily hit poorer families for whom food purchases account for a larger share of their household spending.

Despite these immediate effects, there seems little doubt that the impact of these shocks on the economy will be far smaller than during Russia's previous financial crises of 1998 and 2009. What are the possible reasons for the resilience of the Russian economy? Some experts argue that the adverse external shocks were softened by switching to the floating exchange rate regime that Russia's Central Bank embraced in the aftermath of the 'Great Recession' that began in 2010 and completed when the present crisis hit in December 2014. A very positive by-product of this process has been that more responsible decisions have been taken in recent years by banks and companies because they no longer expect that

the Central Bank will insure them against currency risks in the way it did in 2008, and have therefore improved the balance of their foreign currency assets and liabilities.

A still more significant reason for Russia's resilience could well be the sustained optimism of both businesses and households in the face of the deteriorating economic situation. Opinion surveys suggest that although people clearly recognised that negative developments were hitting the economy, their expectations still remained fairly positive. In spite of the two-fold devaluation of the

Commentary

Yes, the outlook is grim, and it underlines Russia's

Evsey Gurvich suggests that the short-term effects of the sanctions against Russia following its intervention in Ukraine may be more manageable than financial markets initially anticipated. As we all know, markets tend to overreact. Nevertheless, retail sales in Russia dropped by 9.8% and real wages declined 13.2% in April alone. Inflation is now running at 16% and Russia's foreign reserves have fallen from \$500bn to \$360bn.

Certainly, we shouldn't reach premature conclusions from limited data, so we cannot yet conclude that the worst is over and the Russian economy has been turned around.

Gurvich is right to argue that the long-term effects of the sanctions will be more important than the short-term consequences. He correctly draws attention to Russia's inability to catch up with the West if under the current sanctions regime it

cannot benefit from the transfer of technology and inflows of capital from the West. The economic challenges faced by Russia are, however, much more profound than the sanctions. Even when the economic conditions were more favourable and the Russian government was more willing to consider the advice of liberal economists, Russia failed to carry out crucial structural reforms.

The increasing centralisation of the government's powers and the lack both of economic freedom and of commitment to reform points to the improbability of structural changes in the Russian economy. The Index of Economic Freedom published by the *Wall Street Journal* and the Heritage Foundation in the U.S. ranks Russia 143 out of 178 countries, thus placing it with African countries like Guinea and Liberia. And Russia doesn't seem likely to improve its position in the years ahead.

But greater freedom and structural reform are badly needed in Russia.



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rouble, their confidence in the currency was generally unshaken, so that only a small share of Russians' savings were shifted into hard currencies. The explanation of this phenomenon has to be the generally positive mood among most Russians with regard to the accession of Crimea to Russia, whatever the underlying factors influencing these feelings may be.

Where lower energy prices will hit hardest relate to the state's budget. The federal government is expecting a one-sixth drop in its planned fiscal revenues – and that's hardly surprising as

need for structural reform

Low productivity, inadequate levels of investment, poor infrastructure and insufficient human capital are all set to hold Russia back from realising its potential. In the 2000s, the country was able to achieve extensive growth, primarily because of oil revenues boosted by high world market prices. As Gurvich points out, the oil price's stabilisation this year has led to an improvement in projections for the Russian economy.

Relying primarily on oil revenues is no longer enough, as Russia needs to pursue more intensive growth policies capable of increasing living standards. Russia's heavy dependence on oil may well prove more of a curse than a blessing unless the oil revenues are invested wisely and used to diversify the economy. Upgrading the Russian economy will not be feasible without knowledge-based innovation, technology transfers and the diversification of the economic base. The present autocratic political regime in the Kremlin, together with the sanctions, clearly does nothing

to facilitate the flow of technology and ideas across Russia's borders.

Long-term economic developments in Russia will be heavily dependent on the political economy and the consequences of the current sanctions. Hardline elements in the Russian government have strengthened their positions, while those of liberals have been reduced. Russia seems doomed to remain an essentially corrupt rent-seeking society with no prospect of the reforms needed to secure the rule of law. It ranks 62 out of 189 countries in the World Bank's Ease of Doing Business Index, and on ease of dealing with construction permits it is at 152. This makes it more like Venezuela than any European country, and in Transparency International's Corruption Perception Index it ranks 136th out of 174 countries, putting it on the same level as Nigeria and Cameroon. ■

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half of all federal budget revenues come from the energy sector. There will of course be some spending cuts, but at the same time extra spending is needed, for instance to adjust pensions for higher inflation. Overall, fiscal expenditures are to remain almost unchanged, with lower revenues to be covered from the Reserve Fund where windfall gains from high oil prices were accumulated in previous years.

The overall picture is that the immediate effects of sharply declining oil prices and of the financial sanctions against Russia are manageable, the latter effect being less substantial than the former. Lost export earnings attributable to lower oil prices will amount to some \$150bn for the current year, while losses in terms of net capital inflows resulting from financial sanctions are roughly estimated at \$50bn. There is an argument that, somewhat paradoxically, the sanctions may to some degree even be alleviating the consequences of the oil price fall because by making the rouble weaker they are increasing fiscal revenues from the oil sector, which are proportional to the dollar exchange rate. Thus, say some, the most problematic component of the crisis is being softened.

It may well be the long-term effects of sanctions that are the most important, assuming that sanctions are not going to be lifted. Looking to a longer horizon, the lack of foreign loans will be complemented with a lack of foreign direct investment, which is the major channel for inflows of advanced technologies to emerging markets. A good example of this is the restriction being imposed on the supply of equipment for non-conventional oil extraction. The overall bleak outlook is that if the sanctions remain in place, Russia will have very little chance of catching-up with the world's advanced countries, as not only will it not have enough capital but it will also be isolated from the sources of the most efficient technologies. Slower GDP growth combined with declining oil production will result in dwindling fiscal revenues, so the government will have to choose between some equally unattractive options. The longer-term choice facing the Kremlin is either to slash military and social spending or to increase the tax burden and so further retard economic growth. The impact of the sanctions looks likely in the long term, therefore, to be even stronger than that of lower oil prices.

However significant the short and long-term economic effects of the sanctions turn out to be, it seems safe to assume that the most crucial effect will be the influence they will have on Russia's strategic choices for the future. Ever since the start of market reforms in 1992, the major vector of its strategy has been Russia's

integration into the global economy. In just the last decade, we have seen the lifting of restrictions in 2006 on capital flows, Russia's WTO accession in 2012 and the approval by the OECD in 2007 of the 'road map' for Russia's membership. Key elements in Russia's positioning of itself as a member of the international community have been its memberships of G8, G20 and other organisations like APEC and the BRICS.

This situation changed dramatically, of course, a year ago when events in Crimea reversed the trend. Instead of reciprocal steps towards removing barriers to its integration, we now see an inverse logic in which the international economic community is pushing Russia away – the process of Russia's OECD accession, for instance, has been suspended. Russia, for its part, is now pursuing a logic of collision with counter-sanctions being introduced against countries that levy sanctions against Russia. There is also the Russian government's new line on 'self-sufficiency' as a safeguard against any future sanctions.

These new stances undoubtedly have 'lose-lose' economic implications for both sides, but the impact on Russia's strategic choices is less clear-cut. Russia's various elite groups probably have different interpretations of the signals that the sanctions are sending; some see them as evidence that a 'collision strategy' stands in the way of mutually advantageous international collaboration, others that the sanctions must be strongly repulsed. The former argue that Russia's successful development in the globalised world depends critically on its ability to find appropriate patterns of international economic collaboration, and warn that collision leads to isolation and deadlock. The effect of the present sanctions is seen as strengthening the case for a resumption of Russia's longstanding international integration strategy. But there are also elite groups oriented to collision, and they regard the sanctions as proof of external challenges that must be repulsed.

We will doubtless see moves in the foreseeable future supporting both strategies. Russian efforts to find domestic substitutes for the most important import items may well be combined with efforts to resume collaboration with the OECD or other international institutions. My hope is that it will be the first strategy that overcomes, and that we Russians will resume our path towards full integration into the global economy as a vital precondition for the country's future development. ■