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# Russian Economy under Sanctions
## What is the way forward?

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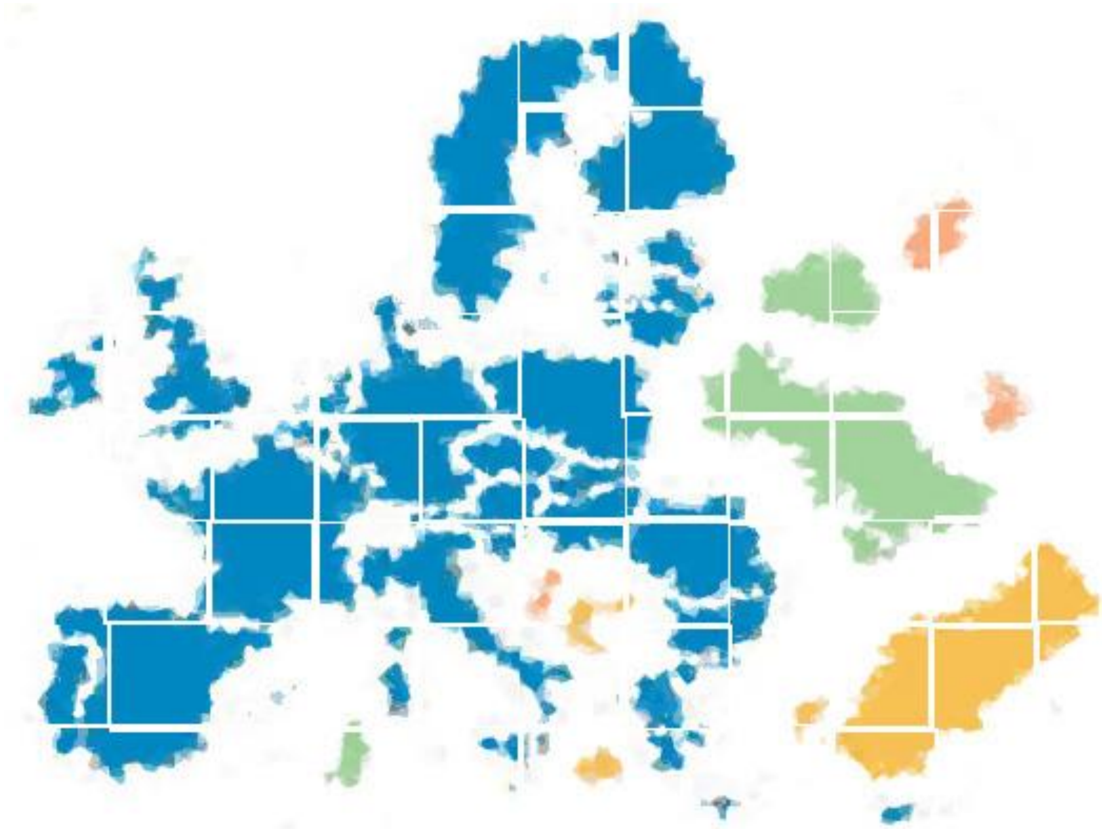

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# Russian Economy under Sanctions: What is the way forward?

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***Abstract***

*The geopolitical conflict with the West over Ukraine and the sharp oil price decline in 2014 exposed the problems the Russian economy had been facing already well before: excessive reliance on the energy sector and poor investment climate on account of 'structural bottlenecks'. In addition, the crisis has been arguably aggravated by an overly restrictive macroeconomic policy response of the authorities. So far the oil price decline has had a greater adverse impact on the Russian economy than the sanctions, but the latter may become increasingly biting over time. Continued reliance on the energy sector will likely weigh heavily on Russia's future growth prospects given the depressed energy prices, sanctions, and the ongoing energy supply diversification efforts in the EU. Therefore, the need for economic modernization and diversification has become even more obvious. However, FDI-driven modernization will be unrealistic in the current geopolitical climate, while large-scale industrial policy would bear a number of its own risks.*

Since Vladimir Putin came to power in Russia in 2000, the country has made important progress in a number of areas. Its per capita GDP in PPP terms increased nearly four times, and the share of population living in poverty fell markedly. Also, following the chaos and the 'state capture' by oligarchs during the 1990s which culminated in the financial crisis of 1998, the 'Putin era' witnessed a remarkable political stabilization. Macroeconomic policies pursued have been generally cautious, as the windfall government revenues from energy exports were to a large extent accumulated in sovereign funds rather than spent on a current basis. At the same time, income inequality and corruption have been generally in the rise, and political stabilization arguably went too far, as democratic institutions were gradually reduced to a mere façade of an increasingly authoritarian regime.

Throughout this whole time period, Russia has been invariably recording sizeable current account surpluses. However, these surpluses have been entirely thanks to energy exports: without those, prior to the current crisis Russia would have recorded external trade deficits to the tune of 7% of GDP and budget deficits as high as 10% of GDP, according to wiiw calculations (these shares dropped however during the crisis). These figures illustrate the heavy reliance of the Russian economy on the energy sector, which is in fact greater than it was in the Soviet Union.

On top of that, in 2013 Russian exports embarked on a downward trend while GDP growth slowed down markedly, to a mere 1.3%. This was largely on account of stagnating investments and despite the oil price still hovering at high levels at that time. Thus, it became increasingly obvious that Russia's growth prospects were increasingly constrained by 'structural bottlenecks', such as poor infrastructure, weak legal system, widespread corruption and as a result unfavorable investment climate – even before the outbreak of the Ukraine conflict and the oil price decline. The famous four 'I's' announced by former Russian President Dmitri Medvedev in 2010 – institutions, innovations, investments and infrastructure – effectively summarized the major weaknesses of the Russian economy and simultaneously served as a list of declared government priorities.

The geopolitical conflict with the West over Ukraine – irrespective of who is to blame for it – has only aggravated those problems. In addition, it coincided with a sharp drop in oil prices starting from mid-2014 onwards, fuelling speculations within Russia that these two developments might be linked with each other. The combined effect of sanctions and the oil price declined pushed the Russian economy into recession, which has continued up until now. Although the recent months have witnessed signs of 'bottoming out' and the economy should rebound slightly in the second half of 2016, for the year as a whole wiiw still projects GDP recession of -0.8%, followed by unimpressive recovery of below 1% in 2017.

The main reason for the crisis has been the sharp depreciation of the Russian rouble, largely because of the oil price decline (the correlation between these two variables over time has been remarkably strong). It pushed up the prices of imported goods and thus the overall inflation, which has eroded the purchasing power of households and depressed domestic demand. Moreover, the impact of the adverse exchange rate shock on the Russian economy has been arguably aggravated by the policy response of the Russian authorities. Monetary policy has been tightened in response to higher inflation, since reasonably low inflation rate (4% p.a.) is the official target of the Russian Central Bank. At the same time, fiscal policy remained generally restrictive and was aimed at keeping budget deficits in check. The observed deterioration of the budget performance in 2014-2015 was entirely 'cyclical' (i.e. essentially reflected the reduced tax collection) rather than a manifestation of fiscal policy relaxation. Even pensions and salaries in the public sector were not fully indexed in line with inflation (unlike e.g. during the crisis of 2008-2009), resulting in falling real incomes of large segments of the population.

Western sanctions played their role, too. There were three types of 'sectoral' sanctions imposed by the West against Russia in mid-2014: financial sanctions (restrictions on long-term borrowing), restrictions on exports of oil-drilling equipment for Arctic and offshore deposits, and restrictions on trade in military and dual-use goods. Among them, it was the financial sanctions which had the greatest immediate impact. Although formally only a handful of Russian state-owned energy companies and banks were sanctioned, financial market conditions effectively deteriorated for other Russian borrowers as well, on account of both increased risk perceptions and pressures from western governments. According to the estimates of Moscow Institute of Economic Forecasting, financial sanctions alone could cost the Russian economy up to EUR 150 billion in the long term. In turn, restrictions on exports of oil-drilling equipment – though not biting immediately – may potentially reduce Russian oil production by up to 70 million tons by 2030, translating into an estimated EUR 25 billion in cumulated losses (assuming average oil price of USD 70 per barrel). All in all, the combined cumulated losses due to western sanctions and their indirect effects – including less FDI inflows from the EU, higher inflation, and the reduction of production cooperation – may reach some USD 700 bn the long term (until 2030), according to these estimates.

The combined effect of economic crisis and sanctions was a sharp decline in Russian foreign trade, particularly with the EU and particularly on the import side: in 2015 alone, imports from the EU plummeted by 30%, largely because of the rouble depreciation. Although there has been much talk at the official level about re-orientation towards China, the statistics prove that trade with China declined as well, albeit not as much. Thus, there has been only relative (but not absolute) re-orientation of Russian trade away from the EU and towards China, at least so far. A breakthrough deal on long-term gas supplies, which was signed between Russia and China in 2014, may signal that such re-orientation will likely gain momentum in the future, although it will require massive infrastructure investments (currently, major Russian oil and gas pipelines go in the direction of Europe). However, it is questionable whether China will be able to substitute Europe as the main source of new technologies for Russia; the latter would be crucial to maintain the current levels of energy production – let alone for the badly needed modernization and diversification of the Russian economy (more on that, see below).

The above suggests that western sanctions are having non-negligible effects on Russia. However, in political terms they proved ultimately counter-productive. It is clear that harming the Russian economy was not the purpose of western sanctions per se. Instead, they were conceived as a tool of bringing about a change in Russia's foreign policy concerning Ukraine – either through popular discontent or that of the country's elites. In reality, the opposite has happened: Russian public opinion largely consolidated around President Putin, resulting in his sky-rocketing approval ratings. With increased domestic support, the Russian leadership feels now generally more confident and assertive – not least in its foreign policy.

With excessive reliance on the energy sector and increased political isolation, Russia appears to be 'stuck in transition' for the foreseeable future. While the energy sector will continue to remain the backbone of economy for the years to come, it may suffer on account of ongoing energy supply diversification efforts in Europe (increased role of LNG and shale gas, more gas imports from Azerbaijan, etc.); increased energy exports to China and Asia in general will likely provide only some relief. Also, as suggested above, the western sanctions restricting the exports of oil-drilling equipment may undermine Russia's energy export potential as well. Finally, even in the absence of the above two factors, low energy prices will enable only sluggish GDP growth, most probably not exceeding 2% per year – which is clearly inadequate given Russia's relatively low development level (around 60% of the average EU level) and its sizeable convergence potential.

Therefore, economic modernization and diversification – long recognized as essential for long-term development prospects – appear to be all the more crucial under the current circumstances. However, while the environment of low oil prices may provide enough incentives for modernization, it simultaneously constrains the financial capacity (of both the private sector and the state) to carry out such modernization. This trade-off between incentives and financial capabilities is nothing new for Russia and has been an essential feature of Russian/Soviet economic policy debates at various points in history.

As exemplified by the successful experience of many Central and East European countries (most notably Czech Republic, Poland, Slovakia, Hungary and Estonia) or, for instance, Ireland, one way to escape this trade-off could be to attract more foreign direct investment (FDI). In principle, FDI inflows from 'advanced countries' such as the EU, the US and Japan could bring not only capital, but – more importantly – also the badly needed advanced technologies and know-how. Needless to say, pursuing such a strategy would require the creation of a conducive investment environment, particularly that for FDI. In all likelihood, this would imply the need for liberalization, deregulation, tax simplification and an overall low tax level, and – above all – institutional improvements, including reforming the legal system and securing property rights. Deregulation and low taxation would mean reducing the role of the state and also prudent fiscal and monetary policies – akin to the ones pursued so far.

Even with all of the above measures in place, it is however highly questionable whether there will be increased inflows of FDI from the West in the current geopolitical climate. Whether this will change for the better with Donald Trump as US president is an open question. In the 'baseline scenario', the strategy of FDI-driven modernization would almost certainly require a fundamental shift in Russian foreign policy – essentially yielding to western pressure, possibly even including a return of Crimea to Ukraine. The latter seems hardly politically feasible.

An alternative to FDI-driven modernization could be, for instance, a more active industrial policy targeting selected sectors of the economy. That such policy can also bring fruits is demonstrated by the past experience of a number of East Asian countries, including for instance South Korea and

Japan. In Russia, industrial policy was already pursued to some extent in a number of sectors over the past two decades, such as in nuclear power, aircraft and ship-building, biotechnologies and pharmaceuticals, and IT. However, apart from the obvious challenge for the government to set priorities right, the main problem with such policy is that it ultimately requires substantial allocations from the state budget: either in the form of subsidies, tax preferences or otherwise. A large-scale industrial policy would also require a substantial easing not only of fiscal, but also of monetary policy – and therefore most probably capital controls. All this would require a radical change in economic policy-making. On top of that, there is a high risk that a large part of the funds allocated within the framework of such policy will be misappropriated or simply stolen.

All in all, while liberalization and deregulation are unlikely to bring the expected benefits under the present circumstances, the opposite strategy of increased state intervention – while politically arguably more feasible – runs a number of risks of its own, and may become outright dangerous if driven to extremes (the experience of the Soviet Union may be a good reference point for that). These constraints speak in favor of a compromise solution; the latter could enable some relaxation of macroeconomic policies and a somewhat increased role of the state without giving up the economic freedoms achieved during the two and half decades of Russia's transition to the market economy. Whether such a compromise is politically feasible, remains to be seen.

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