THE IMPACT OF ECONOMIC SANCTIONS ON THE ECONOMY OF THE RUSSIAN FEDERATION IN THE CONTEXT OF ITS FULL-SCALE AGGRESSION AGAINST UKRAINE

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Before the outbreak of large-scale aggression against Ukraine in 2022, the Russian economy was able to recover and strengthen from the economic damage caused by the COVID-19 pandemic. Its resilience was due, in particular, to the guarantee of high revenues to the state budget from the sale of energy and raw materials, and the creation of significant internal reserves to support economic activity. Also, the high degree of dependence on energy carriers by the EU countries, which had not taken any meaningful steps to diversify their supplies before Russia's invasion of Ukraine, contributed to the effective sale of energy carriers. At the same time, the Russian Federation expanded the range of countries to which it supplies energy resources, particularly in Asia, and continued to build up its supply volumes, which created the preconditions for their further increase in the context of the war with Ukraine.

The imposition of additional and more stringent economic sanctions by Ukraine's allies after the outbreak of a full-scale war did not have an immediate negative effect on the Russian economy. Moreover, the restrictions were introduced gradually and did not create a situation of complete economic isolation of the Russian Federation. This is explained by the fact that sanctions require a long period of time to achieve their maximum effect.

This study attempts to identify the external and internal factors that influenced the resilience of the Russian economy during the first year of the full-scale war. The reorientation of exports to Asian countries, post-Soviet states, and parallel imports from these countries allowed Russia to avoid the collapse of its economy under sanctions pressure and to secure critical imports. However, the sanctions eventually began to have a negative impact on the Russian economy, albeit in a gradual way. This is manifested in the overall decline in Russia's GDP growth, a decrease in the value of Russian exports, and a marked increase in the Russian budget deficit. Also, the financing of the war is growing and further depleting Russia's budget.

In the future, the economic situation of the Russian Federation is expected to deteriorate. This will be especially so if sanctions are tightened, including a full embargo on major Russian exports.

Situation assessment

The state of the Russian economy before the full-scale invasion.

Considering the macroeconomic indicators of the Russian economy before the full-scale invasion, it is worth noting that after the 2020 recession caused by the Covid-19 pandemic, the Russian economy began to recover, exceeding the pre-crisis level in the second quarter of 2021.

Thus, while GDP growth in 2020 was negative and amounted to -2.7%, the following year GDP growth recorded 4.7%. The same situation was registered for almost all economic indicators. Foreign investment increased by 7.6%, exceeding the 2019 figures; the unemployment rate decreased from 5.8% to 4.3%; real household income increased by 3.1%; a federal budget surplus of 0.4% of GDP was recorded compared to the deficit in 2020. The external debt decreased from 3.9% to 3.3% of GDP, and the internal debt decreased from 13.8% to 12.5% of GDP; the balance of payments was positive, amounting to $120.3 billion. Just as importantly, the state's foreign exchange reserves grew, reaching $630.6 billion [1], a record high since 1991.

As for the structure of Russian exports as of 2021, according to the Federal State Statistics Service, fuel and energy products accounted for 54.3% of revenues; metals and products made of them—10.4%; machinery, equipment and vehicles—6.6%; chemical products—7.7%; wood—3.5%; food products and agricultural raw materials—7.3% [2]. Accordingly, the Russian economy, being dependent on gas and oil revenues, has recovered rapidly, in particular, due to the rise in oil prices. For example, the price of Brent crude oil at the height of the pandemic dropped to less than $20 per barrel, and on February 24, 2022, the price reached more than $101 per barrel [3]. Similar processes occurred with gas. In May 2020, gas cost $1.5 per million British thermal units (MMBtu), and in December 2021, it cost $37.4 per million British thermal units [4].

It is also necessary to consider the main directions of Russian exports in 2021. In particular, 49% of Russian crude oil exports went to Europe, where the largest importers were the Netherlands (13.45%), Germany (10.29%) and Poland (5.88%). Imports by other European members of the Organization for Economic Cooperation and Development amounted to 19.33%.

Countries in Asia and Oceania imported 38% of Russian crude oil, with 29.62% going to China, 3.36% to South Korea, and 5.25% to the rest of the region. Russia exported the remaining 13% to other countries, including Belarus (6.30%) and the United States (4.20%) [5].

European countries' dependence on Russian gas was even more striking. 74% of gas exports went to Europe, where the largest importers were Germany (19.19%), Türkiye (10.72%), France (7.00%) and Poland (4.18%).

13% of Russian gas exports went to Asia and Oceania, where the largest importer was China (6.32%), and the remaining 13% went to the rest of the world, where Belarus imported 7.90% of Russian gas [6].

Accordingly, the conditions for the Russian economy on the eve of the full-scale invasion were perhaps the most favorable in the last decade, which is justified by the largest GDP growth since 2010 [7], the accumulation of record gold and foreign exchange reserves, and high energy prices, as mentioned above.

The Russian economy after February 24, 2022.

Many Ukrainian and foreign experts predicted a critical deterioration in the economic situation for Moscow due to the unprecedented sanctions restrictions. Indeed, the Russian Federation became the country subject to the largest number of sanctions in the world [8], and Western countries cut off a number of Russian banks from SWIFT [9].

Despite this, the decline in real Russian GDP in 2022 did not exceed 2.1%, unemployment fell to a historic low, the consumer price index rose by 11.9%, the RUB/USD exchange rate, after falling in February 2022, appreciated rapidly in March, and by the end of the year, the nominal RUB/USD exchange rate was only 4.7% higher than at the end of 2021 [10].

The consequences of the restrictions for the Russian economy proved to be less than devastating, and Moscow generally weathered the past year well. Several factors contributed to this abnormal situation:

1) High oil and gas prices. The price of one barrel of Brent crude oil was the highest since 2014, when it cost $115. In March 2022, one barrel of this brand could be purchased for $129 at the peak of the price. Such high prices remained until June, when the cost of this natural resource began to decline from $128 per barrel to $82.5 in December of the same year [11]. Similar processes took place in the natural gas market, when prices remained consistently high throughout the year, and in August there was a historic spike, as a result of which the price per million British thermal units (MMBTu) was more than $70 [12].

2) High gas and oil revenues of the Russian Federation. As a result of high energy prices, the Kremlin was able to receive excessive profits from oil and gas exports. Specifically, according to the Central Bank of Russia, Moscow's foreign trade turnover in 2022 amounted to $973.9 billion, which is 4.7% higher than in 2021. The foreign trade balance amounted to $282.3 billion, which is 66% higher than in 2021.

Despite a decrease in the physical volume of goods exported abroad due to a record increase in energy prices, the value of exports has substantially increased. Thus, last year, exports of goods and services from Russia amounted to $628.1 billion, exceeding the figures for 2021 by 14.2%, and the price volume of mineral exports in 2022 exceeded the figures for 2021 by 40.8% [13]. It is worth noting that exports of mineral fuels, oil, and petroleum products accounted for 65% of all Russian exports [14].

3) Russia's largest gold and foreign exchange reserves in history. As noted earlier, the post-crisis economic recovery and rising energy prices allowed Russia to achieve economic growth of almost 5% by the end of 2021. Economic agents were accumulating their reserves in anticipation of future growth. The financial performance of companies was three times better than in 2020, which increased their resilience to shocks. The drop in corporate sector profits became noticeable only in the third quarter of 2022 [15].

4) Changes in the geographical structure of Russian exports. The gradual refusal of Western countries, primarily European states, to import Russian goods has forced Moscow to reorient itself to Asian countries. For example, the Kremlin has significantly increased trade with Central Asian states. In 2022, Russia's trade turnover with Kazakhstan was up 10% [16], trade with Tajikistan grew by 22% [17], with Kyrgyzstan by 40% [18], and with Turkmenistan by 45% [19].Data from Russia's main trading partners and data from the Ministry of Economic Development of the Russian Federation on trade with Belarus show that the total trade turnover with China, Türkiye, India, and Kazakhstan amounted to 43%, compared to 32.4% in 2021 [20].

China became the largest trading partner of the Russian Federation, and trade with it reached a record high of $190.27 billion, up 29.3% compared to 2021 [21]. Russia has increased gas supplies through the Power of Siberia pipeline by 1.5 times, reaching a record high of 15.5 billion cubic meters [22]. Moscow also stepped up oil exports to China by 8% compared to 2021 [23].

In addition, Russia has greatly expanded its oil exports to India—by 22 times, and Beijing and New Delhi accounted for 70% of all Russian oil exports as of the end of 2022 [24].

5) Tight control of the ruble exchange rate. During the first days of the invasion, the Board of Directors of the Bank of Russia decided to raise the key interest rate to 20% per annum [25]. Russians who wanted to buy euros or U.S. dollars at the time of the national currency's depreciation had an incentive to keep their savings in rubles after the key interest rate was raised, which reduced pressure on the national currency.

The government demanded that 80% of the income that Russian companies receive abroad should be exchanged for rubles [26]. The requirement to convert 80% of foreign revenues into the national currency has created a robust demand for the Russian currency, thus keeping it strong.

The Kremlin also banned Russian brokers from selling foreign-owned securities [27]. As a result, the government strengthened the stock and bond markets, keeping money inside the country, which helped keep the ruble from crashing.

Russian citizens faced a ban on transferring money abroad imposed by the Russian government [28]. The initial ban included the suspension of all foreign currency loans and transfers, which contributed to the retention of foreign currency in Russia and prevented Russians from exchanging rubles for foreign currency.

Hence, the Russian economy has survived the harsh sanctions due to excessive profits from rising mineral prices, a policy of accumulating reserves to protect the Russian economy from external shocks, skillful manipulation of the national currency exchange rate, and Russia's ability to partially reorient its exports to the East as Western countries began to increasingly refuse Russian energy.

In the event of a breakthrough success on the battlefield and the collapse of Ukraine's defense, Moscow would emerge from the conflict not only without economic losses, but also with huge gains caused by rising energy prices and the inability of European countries to immediately diversify their energy supply sources.

Despite the short-term success of Russia's economic policy, this year we can see signs that the Russian economy will face a number of systemic problems in the medium and long term.

Indicators of challenges in 2023

In 2023, signs are emerging that the short-term success of Russia's technocrats may face significant challenges in the longer term.

Although Russia's GDP declined by 1.9% in the first quarter of 2023 [29], in part due to increased budget spending since the end of 2022 [30], it will be more difficult for the Kremlin to generate the same high profits from energy exports.

This is primarily due to the fall in gas and oil prices that began in the third quarter of last year. Thus, one barrel of Brent crude oil as of May 2023 cost approximately $74, which is 34% less than in the same time frame last year [31]. The price of gas has also shrunk significantly to $13.5 per million British thermal units (MMBtu) [32].

As a result, the value of Russian exports decreased by 35% in the first quarter of 2023. According to the Central Bank of the Russian Federation, this was caused by "a deterioration in the price environment on the world market and an increase in the discount for Russian oil" [33], which was caused by the introduction of a wall ceiling on Russian oil by the G7 countries, Australia, and the EU [34].

There has also been a major jump in the Russian budget deficit, which has exceeded the annual plan by 850 billion rubles. At the same time, the federal budget deficit increased by 1.02 trillion rubles in April alone [35].

Along with the above, Moscow has to spend more on fighting in Ukraine. Army spending in January-February 2023 increased by 282% compared to the same period last year, resulting in the Kremlin spending $26 billion to continue its aggression against Ukraine [36].

Although unemployment in Russia has decreased to a historic low of 3.5%, this is due to the outflow of personnel from the Russian Federation—the labor market has shrunk by 1 to 1.5 million people due to emigration and war [37], the transition of a number of enterprises dependent on Western components to part-time or unpaid downtime, and the growing need for labor at defense enterprises [38].

Projections and prospects

The speed and intensity of the impact of economic sanctions against Russia is limited by the fact that Russia is a rather “hard target” for restrictions due to its weighty role in the global economy, in particular as an exporter of important raw materials such as fuel, fertilizers, and precious metals [39]. The immediate isolation of Russia from its main trading partners could potentially cause serious economic damage to those countries that would resort to such a measure. That is why, unfortunately, sanctions against Russia have been imposed incrementally since the beginning of its large-scale aggression. Even despite the existing set of restrictions, the International Monetary Fund forecasts that Russia’s GDP will grow by 0.7% in 2023 [40].

However, the restrictions are likely to remain effective, as they will have a cumulative effect that could cause long-term damage to the Russian economy and eventually lead to a significant economic downturn in Russia. The likelihood of such a scenario in the long run is also facilitated by the aforementioned problems that are brewing in the Russian economy. According to a study by the KSE Institute, in 2023, the cumulative effect of sanctions may grow and, as a result of this scenario, the rate of decline in Russia’s GDP may accelerate to 8% [41]. One of the main restrictive measures that may contribute to this is the already imposed restrictions on the price of Russian oil, which may increase further at the initiative of Ukraine’s partners this year.

The loss of the European Union as a major gas buyer will also have a long-term negative effect on Moscow’s economic situation. Josep Borrell, the head of the EU’s foreign policy service, predicts that 2023 will be a difficult year for the Russian economy due to the deterioration of many macroeconomic indicators in Russia, but a rapid economic decline should not be expected since sanctions have a cumulative effect [42].

In this context, it can be predicted that Ukraine's partners, primarily the European Union and the United States, will continue to gradually impose broad economic restrictions on Russia in the form of comprehensive sanctions packages, similar to those they have been applying since the beginning of the full-scale invasion. This will also add to the cumulative effect of the sanctions, but will not have an immediate material impact on the Russian economy.

Despite the existing sanctions on a wide range of Russian goods and raw materials, the issue of imposing restrictions on imports of metals and jewelry from Russia to Ukraine's partner countries remains a pressing one. Limitations on such categories of goods are not actively applied by the allies of Kyiv due to the considerable share of Russia as a supplier of metals and jewelry. In particular, the Russian Federation continues to be one of the suppliers of diamonds to the European Union and in 2022 supplied them for about $1.46 billion [43]. Belgium, the EU's "diamond hub," remains the main importer of precious stones. The beneficiary of the diamond sales is the Russian company Alrosa, which is controlled by the Russian government and is actively involved in financing Russia's military actions against Ukraine. No material sanctions have been imposed against this company, except for its management [44].

In addition, supplies of platinum group metals, whose exports to Western countries in 2022 brought $3.8 billion in revenue to the Russian budget, are not subject to restrictions. Platinum and other platinum group metals are widely used in the automotive industry, which is well-developed in most Western countries. In addition, Russia's share of nickel imports to the EU is almost half, and nickel exports bring Russia almost $3.8 billion [45].

Given the importance of supplies of this type of goods and resources from Russia to Western countries, sanctions on them can be expected if a way is found to increase the diversification of supplies and find new economic partners, which may take an indefinite amount of time. However, if such restrictions are imposed, Russia will be deprived of an additional source of budget revenues.

As for Russia's efforts to protect its economy from the impact of sanctions or finding ways to circumvent them, the Russian government is likely to focus on the following:

1) Diversification of exports of goods, services, and raw materials with an emphasis on Asian and post-Soviet countries that have not taken restrictive measures against Russia.

2) Further deepening economic relations with such countries, in particular through the development of regional economic integration structures.

3) Building a mechanism for the supply of scarce goods and high technologies bypassing sanctions, in particular by importing such goods through third countries that have not imposed sanctions on Russia or do not comply with restrictions imposed by Ukraine's allies.

In the context of diversifying exports and economic relations in general, Moscow will continue to pay considerable attention to China. In 2022, the trade turnover between the two countries grew to $190 billion [46]. However, economic relations between Russia and China are not equal, given the greater role and weight of China in the global economy and the nature of economic exchanges between the countries. Russia, in fact, acts as a raw material appendage for the resource-intensive Chinese industry. It is the second largest supplier of oil to China and the fourth largest supplier of liquefied natural gas [47].

In turn, China supplies Russia with high-tech goods and other products of the machine-building industry. In addition, Russia receives semiconductors and microchips from China, which are important for high-tech goods, despite the ban on the supply of such goods from Western countries [48]. In such circumstances, Russia intends to further deepen its economic ties with China, with a focus on the currency sphere. Thus, during the visit of Chinese President Xi Jinping to Moscow in March 2023, Russian President V. Putin announced his desire to use the Chinese yuan to settle accounts with Russia's partners, primarily Asian and Latin American countries [49]. This means that Putin is attracted to the concept of "yuanization" of the Russian economy in order to reduce the role of the US dollar as a settlement currency in economic exchanges with partners.

With regard to export diversification, Russia is already trying to improve economic ties with regional partners. After the imposition of sanctions on Russian gold exports, the Russian government significantly increased supplies of this metal to Türkiye, China, and the United Arab Emirates. In particular, the UAE imported 75.7 tons of gold from Russia in 2022, compared to 1.3 tons in 2021. The Russian Federation supplied about 20 tons of gold to Türkiye and China each [50].

The practice of parallel imports of essential goods to Russia is also picking up steam. For example, a large number of sanctioned goods from Germany enter Russia through post-Soviet countries that did not impose economic restrictions. This can be seen, in particular, in the growth of exports from Germany to certain countries. Last year, German exports to Armenia, Kazakhstan, and Georgia doubled, and the largest growth was in Kyrgyzstan, rising by 994% [51].

Given the gradual increase in sanctions pressure on Russia, the government will keep trying to diversify its foreign economic activity to obtain scarce goods and boost budget revenues using the above methods.

Conclusions

Many external and internal factors affected the resilience of the Russian economy during the first year of the full-scale war. First, the surge in prices on the global energy market allowed Russia to ensure budget revenues from the sale of energy resources, even as Western countries refused to buy Russian fuel. Also, Russia has simultaneously stepped up gas and oil supplies to friendly countries such as China to compensate for the loss of the European market. However, the Russian government has to sell its energy resources at a much lower price.

The reorientation of exports to Asian countries and post-Soviet states, and parallel imports from these countries, also helped to avoid the collapse of the Russian economy under the influence of sanctions and to provide itself with the necessary goods. Strict control of the ruble exchange rate prevented rapid inflation, and internal regulatory measures related to capital control curbed the outflow of funds from Russia and slowed the deterioration of the economy.

Yet, the sanctions imposed have begun to have a negative impact on the Russian economy, albeit a gradual one. This is indicated by a general decline in Russia's GDP growth, a decrease in the value of Russian exports, and a substantial increase in the Russian budget deficit. In addition, falling energy prices and the introduction of an upper limit on energy purchases by the EU seriously reduce the profitability of Russian fuel exports compared to the beginning of a full-scale war. In addition, the financing of the war is growing and further depleting Russia's budget, as active hostilities require a significant amount of financial resources and the prospect of the economy being put on a war footing if the war is prolonged.

In the future, Russia's economic situation may deteriorate with the further introduction of new sanctions packages and the expansion of the range of goods subject to bans. To avoid even greater damage from the sanctions, Russia will continue to diversify its exports, deepen economic ties with its allies, and focus on developing internal capabilities to support its economy in the face of isolation and loss of major export markets. An even faster and more significant blow to Russia's economy could be inflicted by introducing much more severe restrictions, up to a complete embargo on major exports from Russia.

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