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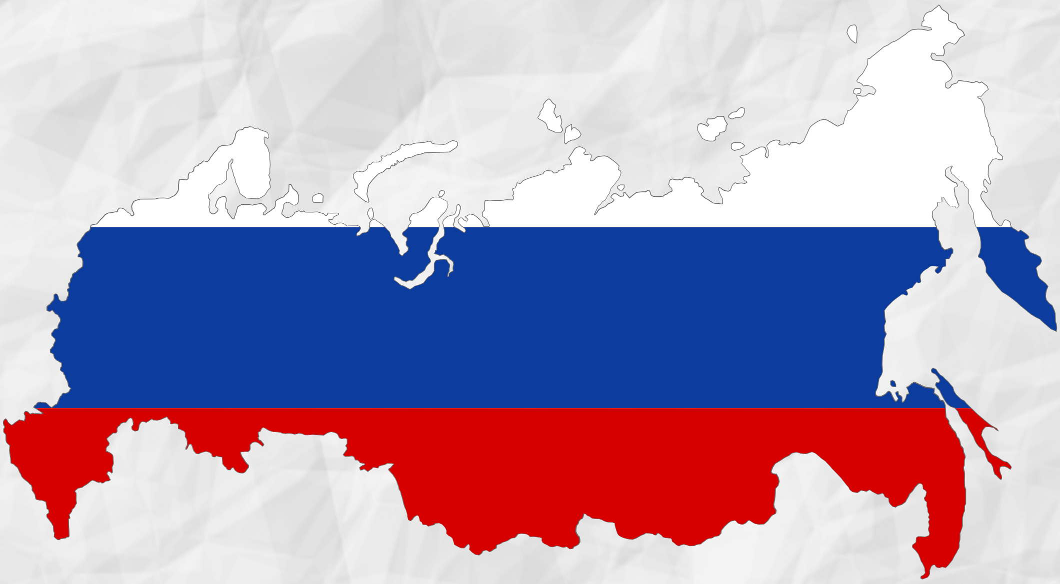

Why sanctions on Russia are working

by Vladimir Milov

Vladimir Milov

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SANCTIONS ON RUSSIA ARE WORKING. PATIENCE IS NEEDED

The effectiveness of Western sanctions imposed on Russia after Putin's aggression against Ukraine on February 24th, 2022, remains a hotly debated topic. Many observers expected a much more serious effect of sanctions on the Russian economy; many are disappointed that sanctions have had only limited effect and did not lead Putin to stop his aggression. There are several international commentators who suggest that the sanctions did not have a desired effect, and that Russia is showing resilience and somehow "weathering" them.

Discussion on the actual effect of sanctions is a particularly important one and requires a truly in-depth look at what happened to the Russian economy during 2022. Most Western analyses, unfortunately, omit this in-depth review, concentrating only on a narrow number of macroeconomic indicators, which are often misrepresenting the situation in the economy and highly manipulative.

To begin with, it is not clear why some people think that sanctions would lead to an immediate collapse of the Russian economy. Russian dependence on imports, foreign investment and technology is high, but still only partial.Russian financial reserves at the beginning of the war were significant ($175 billion in the National Wealth Fund alone), allowing Russia good safety margins. Several large countries – notably China, India, Turkey, Israel, Central Asian countries, etc. – have not participated in the sanctions, allowing Russia to ditch some of the hardest impacts of sanctions through increased trade with these countries and securing access to some technology this way. The Russian government introduced harsh regulatory measures like de facto revoking the free convertibility of the ruble, introducing tough capital controls to prevent money fleeing the country, etc., which has temporarily helped it to minimize worst-case scenarios. The oil prices have jumped in the first months after the war, allowing Putin to accumulate significant budgetary surplus in the first half of 2022.

After certain sanctions have been imposed on Russia following its 2014 invasion in Ukraine, Putin has been doing a lot to protect the Russian economy from further sanctions – promoting import substitution, attempting to increase trade with non-Western economies (primarily Asia), converting some of Russia's international monetary reserves from dollars to Chinese renminbi, introducing the Russian alternatives to Visa and Mastercard (the Mir payment system), and introducing a national financial messaging system (SFPS) as an alternative to Swift. Despite all these measures not being too effective, they have still somewhat shielded Russia from certain effects of current Western sanctions.

Closer to the end of 2022, it became more and more visible that sanctions are indeed having a wide impact on the Russian economy across various sectors and markets. Supply, demand, investment – everything was seriously affected, and there are only limited – or, in some cases, almost none – options for Putin to improve the situation. Let us have a closer look.

Assessing the effect of sanctions: do not fall for "Potemkin" indicators

Immediately after sanctions were imposed in February 2022, Putin's government began to classify some vital statistics about the Russian economy. Foreign trade, some important budgetary data, financial reports by banks and companies are among the statistical items that were prohibited from being published. That should serve as an important indicator of serious trouble in the first place. If Russia can manage the sanctions just as Putin and some Western commentators would want you to believe, then the Russian authorities would not have been hiding this vital data – unless there is something bad, they do not want you to see.

On the other hand, the Russian government began focusing the public discussion on a handful of manipulated macro indicators ("Potemkin indicators"), which, on surface, portray the situation as if it is under control and normal. Among these are the GDP contraction (which has been relatively modest), strengthened ruble exchange rate, low unemployment, budget surplus, inflation seemingly brought under control after spikes in the spring.

However, if one takes a good look at what is behind all these indicators, their credibility becomes questionable. GDP dynamics include increased military spending and procurement, which have a zero-multiplying factor in terms of further distribution of added value across the economy. For instance, a newly produced battle tank sent to the front in Ukraine and immediately shot down by a Javelin missile still counts as a positive addition to the GDP. Other indicators show much deeper non-military economic contraction (read more below).

A strengthened ruble exchange rate came at a price of full destruction of the ruble's free convertibility for the first time in more than three decades. Since the beginning of the war, the Russian Central Bank has been introducing draconian currency controls and restrictions that have effectively ended the free trade of the Russian currency – as The Wall Street Journal says, the ruble was put into a "Central Bank-induced coma". Since then, Russian officials and businesses have numerous times officially recognized the multiple negative effects of nominal strengthening of the ruble – for the budget, for the exporters – without any positive effects at all.

But Russian authorities are clearly refraining from obvious steps required to weaken the ruble. Why? Because they want to keep the nominally strong ruble exchange rate for political and psychological reasons: a strong ruble is brought up by ordinary Russians as the psychological indicator of economic calm and is also easily picked up by international economic commentators as a sign that the Russian economy is "withstanding the pressure of sanctions". Meanwhile, this economy continues to suffer from the artificially strong ruble – like the steelmaking industry, which experiences a major output contraction (see below for details), with the strong ruble being one of the major contributing factors. This happens at the same time as several Western commentators continue to use the example of the strengthened ruble as often the only argument to "prove" that "sanctions are not working" (which means that Putin's psychological operation aimed at the Western economic community is somehow working).

Low unemployment" is the trickiest of all the "Potemkin indicators". Official numbers suggest that unemployment currently stands at 3,9 percent, with only 2,9 million Russians being unemployed. That is a record low – great achievement, is it not? However, this is not the first crisis when the Russian authorities are putting significant pressure on the employers to make sure they do not lay people off but instead continue to nominally keep them "employed" on paper without paying them. The tough Russian labor law also makes layoffs more difficult for employers. Various forms of hidden unemployment include unpaid leave, downtime, and part-time working week.

Rosstat provides quarterly data on all these forms of hidden unemployment, but it is not particularly publicized and not easy to find – a small-font table at the bottom of page 229 in the monthly nationwide statistical report. But when looked at, the figures are striking: 4,7 million Russians are currently affected by all these various forms of hidden unemployment. 70 percent of them - 3,3 million - are on unpaid leave. That alone is higher than the official unemployment figure of 2,9 million! And the number continues to grow – in Q3 2022, the total number of workers on unpaid leave has grown by about 500,000 people as compared to Q2.

If you add hidden unemployment to the officially stated unemployment numbers, the result is 7,6 million people, or over 10 percent of the total Russian workforce. Last time Russia had that high level of unemployment was in mid-1990s.

The federal budget surplus initially emerged because of a surge in oil prices during spring 2022, and at the end of May 2022 had grown to RUR 1,5 trillion (it is difficult to convert such an amount into US dollars, due to de facto elimination of the ruble's free convertibility, but it is about 5,5 percent of the total currently planned federal budget expenses for 2022). But at the end of September 2022, it was eroded, due to declining revenues (read more below) and increased spending. In early December 2022, the Russian Ministry of Finance has revised its 2022 federal budget deficit forecast from earlier 0,9 percent of GDP to 2 percent GDP. The money from the government's rainy-day fund, the National Wealth Fund, is being used to finance the deficit, which also sparks inflation hikes. Days of praising the budget surplus are over long since.

While annualized inflation peaked at 17,8 percent in April and paved way to deflation in subsequent months, lowering to around 13 percent in the autumn, monthly inflation has started to grow again in September. Deflation has ended after just four months. Extensive deficit spending is clearly contributing to inflationary trends, and this will accelerate as the National Wealth Fund (NWF) is being spent to cover the budget deficit (the actual mechanism of NWF spending to finance the current expenses is not very much different from monetary emission).

It is also worth noting that the official Russian methodology of calculating inflation is not trustworthy – which means that the actual inflation is severely underreported. One of the explanations for this is that the Rosstat is using an artificially low proportion of food to calculate the inflation basket – just 37–38 percent, whereas, by any reasonable available surveys, the share of food in an average Russian's consumption basket is around 50 percent or higher. The other reason is that official accounting of food prices dynamics is non-transparent and probably manipulated – there were many media publications in the past decade (particularly since 2014, when inflation spiked following the invasion of Ukraine and collapse of the oil prices) when journalists actually tracked the prices of basic food items and found the dynamics to be much higher than the officially reported price growth for those items. Even the official numbers of food inflation are higher than overall inflation – but Rosstat continues to maintain a relatively high share of durable goods in the Russians' consumer basket, even though Russians do not spend around 10 percent of their monthly incomes on buying cars, furniture and construction materials.

The Russian Central Bank also regularly publishes the data on "observed inflation" based on public surveys – which level of inflation people observe themselves. During most post-war months, it stood well above 20 percent, currently standing at about 18 percent at the end of November – about 5 percent higher than the officially reported inflation.

Underreported inflation also means that the real Russian wages and pensions decline more rapidly than the official data suggests. Rosstat reports only a modest contraction of real incomes, wages, and pensions (within 1,5–2 percent), but at the same time, retail sales have plunged by 10 percent – the Russians obviously spend less not because they are saving more (there is no data to support that kind of assumption), but because their incomes have contracted much more significantly than officially reported.

Despite a relatively calm picture portrayed by "Potemkin indicators" (GDP, exchange rate, unemployment, budget surplus, inflation), other available data suggests a much more serious contraction in economic activity.

Real data: economy is slowly, but surely collapsing

Some of the economic indicators are characterizing the situation in the Russian economy much better than the "Potemkin indicators". Unfortunately, these do not generate as much attention as GDP, exchange rate, unemployment, or inflation – but they are much more reliable examples of direct data showing how much the economic activity is depressed.

The first suggested indicator is hidden unemployment as discussed above. Rosstat publishes quarterly data on the total number of employees with reduced worktime, usually two months past the relevant quarter, so it should be tracked. In the Russian manufacturing industries, for instance, the number of employees under various forms of hidden unemployment (unpaid leave, downtime, and part-time workweek) reaches as high as 25 percent. That is not an indication that the Russian economy is "weathering the sanctions well".

The second suggested indicator are non-oil and gas revenues of the federal and regional budgets. This data shows to what extent business activity is depressed, so that enterprises cannot afford to pay taxes. Usually, the tax collecting administration in Russia was quite tough: growth in non-oil and gas tax revenue always significantly exceeded GDP growth in the past few years, and businesses always complained about the pressure from the governmental tax revenue agency as one of the key factors constraining performance and development. Many entrepreneurs faced criminal persecution and jail time for tax evasion, which is widely known. In this regard, when businesses choose to pay less taxes, it means that they are in serious economic trouble – otherwise one would not want to mess with the perilous tax revenue agency.

Non-oil and gas revenue was down year-on-year by 6 percent for 10 months of 2022, and by 20 percent in October 2022 alone. Tax revenues of regional budgets (which collect mostly individual income taxes and corporate profit taxes; VAT is 100% federal taxes) fell by 6,6 percent in October, for the first time since the 2020 Covid pandemic.

The third suggested indicator is cargo turnover: with economic activity being depressed, economic agents typically ship less cargo. In September-October 2022, the cargo turnover in Russia was down to around 7 percent year-on-year, significantly worse than in the previous months after the beginning of the war.

The fourth indicator is retail trade. When economic activity is down, people obviously buy less goods. The total retail sales fell by about 10 percent year-on-year in April and remained largely at the same level of about 10 percent less than during the relevant months of 2021 until now. After the beginning of mandatory mobilization in September 2022, retail trade slipped further – which was even officially recognized by Putin during a meeting with his economic ministers in October.

A sharp drop in retail sales is inconsistent with the reported modest contraction of the Russians' incomes. Rosstat reports only an 1,7 percent year-on-year contraction of real disposable incomes for 9 months of 2022 (this data is published on a quarterly basis), 1,5 percent contraction of real wages and 2 percent contraction in real pensions. However, it is impossible that the Russians should have retained basically the same level of incomes but have somehow chosen to spend about 10 percent less. No growth in savings has been recorded which can explain this paradox. True explanation?

Probably the trick is the above-mentioned inflation calculation methodology: real incomes are inflation-adjusted, so under-reported inflation produces a much better picture of real incomes dynamics than the actual reality. This is another strong argument to question the credibility of the Russian official inflation figures.

It is also worth noting that the calculation of "real disposable incomes" of the Russians is based on tricky and obscure methodology, which has been changed twice during the past three years by Rosstat. "Real incomes" should not be considered a trusted indicator.

The fifth set of indicators is related to industrial output. On the background of concealing vital statistics, industrial dynamics are still being reported, and they are not looking pretty. Main contraction is taking place in the most complex manufacturing industries, which are heavily dependent on Western technologies and component parts. There has been plenty of reporting on the collapse of the Russian carmaker industry, where output was down by 66 percent year-on-year during the 10 months of 2022. But it is not just the carmakers: in October 2022, manufacturing of vehicles, trailers and semi-trailers fell by 55 percent year-on-year, manufacturing of other vehicles and equipment by 8 percent, woodworking by 20 percent, textile production by 10 percent, machinery and equipment by 7 percent, etc. In some sectors, the situation is rapidly deteriorating, in October 2022, rolled steel production fell by 16 percent, much stronger than in previous months. Russian steelmaking industry is seriously suffering from sanctions and also from the above-mentioned artificial strengthening of the ruble.

One would expect some of the consumer-oriented sectors might benefit from a sudden opening of the large import substitution niche – but, as a matter of fact, this is not happening. The output of food products has increased by only 0,4 percent year-on-year after 10 months of 2022; drinks by 3,7 percent, but down to just 0,3 percent year-on-year in October. The pharma industry has grown by nearly 18 percent year-on-year after 10 months but fell sharply in October by 8,5 percent, because the high reliance on imported crude drugs is beginning to bite after the low-hanging-fruit import substitution potential has expired.

Things are beginning to look grim in the extractive industries as well. In October 2022, the production of hard coal fell by 7 percent, and of natural gas by 20 percent, because of an EU coal embargo and the self-imposed embargo on Gazprom's gas sales to Europe. Things are not looking too bright for the Russian oil industry: in October 2022, a contraction of output of 1,3 percent year-on-year was recorded, which is just the beginning: the decline will accelerate as the EU oil embargo comes into effect.

The collapse of natural gas exports and huge discounts for Russian oil demanded by Asian consumers have caused the oil and gas revenues of the Russian federal budget – the sixth proposed indicator – to fall as well: they contracted by 6 percent year-on-year in September 2022 and by striking 23 percent in October 2022 (if a one-time extra gas production tax payment by Gazprom in October is not accounted for). A sharp drop in gas exports and the looming oil embargo will cause Russian budget revenues from oil and gas to drop further.

The seventh proposed indicator is fixed investment. Currently, the government is boasting about an impressive year-on-year growth in fixed investment – plus 5,9 percent after three quarters of 2022. But the detailed picture here is not so bright as Russian authorities would want it to be. A significant growth in capital investments is observed mostly in sectors either directly related to the war or irrelevant to real economy – in the transport sector by 11 percent year-on-year (primarily railroads), in public administration and military security by 17 percent, in "professional, scientific and technical activities" by 33 percent, and in financial, insurance and real estate activities by 13 percent.

The figure of capital investment growth in the construction sector looks impressive – 23 percent year-on-year after three quarters of 2022. However, the construction boom recorded in the beginning of 2022 is long gone; while in the first and second quarters of 2022 commissioning of residential buildings stood at 65 and 25 percent year-on-year respectively, it fell to just 1,7 percent in the third quarter, and to 11 percent in October, so the trend in the construction sector is clear.

The same is true for the extractive industries: we see a significant year-on-year growth in fixed investment after three quarters of 2022 (plus 10,6 percent), but it will not save these industries from the above-mentioned troubles arising from European energy embargo, so surge of capital investments here would hit the demand ceiling very soon.

In such vital sectors as manufacturing industries and trade (over 60 percent of the economic turnover in Russia), fixed investment was contracted after three quarters of 2022 year-on-year by 1 percent each, in agriculture by 6,6 percent, and in telecommunications by 17 percent.

Therefore, a cross-sectoral look at a wider set of indicators, showing a more realistic picture of economic activity in various sectors of the Russian economy, suggests that sanctions are having a deep and wide impact across all the segments of the economy, that economic contraction is much deeper than some of the macro indicators suggest, and that negative effects are progressing over time, so there is no actual economic recovery going on.

Social and political implications of sanctions

Many observers are wondering when the sanctions and economic downturn will force the Russians to protest the government and demand political change, and Putin's elite challenge him and his policies. There is, however, no immediate and direct link between these components. Putin's elites are too loyal, controlled and scared after more than two decades of intimidation, negative selection, and domination of security services over the state apparatus. Ordinary Russians have been protesting en masse until 2021, when political repressions were elevated to a totally new level: activists began to face long jail terms for legitimate political activity (see the "extremist community" criminal case against the network of Alexey Navalny supporters), and after the beginning of Putin's war against Ukraine on February 24th, new punishments were introduced for "spreading fakes about the Russian army" (or, in other words, speaking the truth about the war) up to 15 years in prison each. With these realities, building up a momentum for mass protest will take time.

But at the same time, economic troubles would inevitably take a toll on Russians. According to various estimates, before the beginning of the war in February 2022, the Russians' real incomes have fallen by about 10–15 percent as compared to pre-2014 levels; in 2022–2023, they would clearly deteriorate further. By the end of next year, Russians may find themselves at least by 20–25 percent poorer on average than before Putin's invasion of Ukraine in 2014. The consequences of Putin's aggressive foreign policy will undoubtedly assess the Russian population’s limits of patience – particularly when there is no positive hope for dramatic improvement of the situation unless Putin changes his policies. Russia has already seen real mass protests in 2017–2021, which were temporarily quelled only with mass repressions unseen in generations, but there is no reason to think that the protest mood has disappeared.

At the same time, living standards continue to deteriorate sharply on all fronts, which is widely recognized even by the state-linked opinion pollsters and survey groups. According to October Romir data 68 percent of the Russians noticed a reduction of retail assortment and a reduction of supply in stores over the past three months, especially in the non-food category. Most of all, consumers are missing the departed brands of household appliances and electronics (57 percent), cars (53 percent), non-food products and clothing and footwear (50 percent each). According to WCIOM pollster, in 2022, 35 percent of the Russians were forced to cut their spending on food, 32 percent, and on barbershops, beauty salons and cosmetics. FOM pollster reports that only 23 percent of the Russians are considering their personal financial situation to be "good". According to Verstka media outlet, which studied the official statistics of the Judicial Department at the Supreme Court of Russia, petty theft in Russian department stores went up with 17 percent in 2022 (the total number of cases opened for petty theft). RBK reports, referring surveys by Rabota.ru and SberPodbor job services, that 63 percent of employers do not plan to pay New Year bonuses to their employees this December – as compared to 35 percent a year ago.

According to a survey by Roskachestvo and NAFI, about a third of the Russian population noted a decline in their quality of food. The market for spare parts for Western-designed cars and computer hardware is exploding, prices have risen as much as two to three times on many items. Soon the Russians will have to drive mostly domestic cars and use domestic computers, which they certainly would not like.

Russians have traditionally tried to shield themselves from decline of incomes by borrowing more from banks. The total individual debt to annual wage fund ratio was up from 55% in 2015 to 84% in 2021; it is moving closer to 100% as the result of the 2022 crisis. Excessive credit burden on the background of falling incomes leads to deteriorating solvency of the Russians: in October, overdue consumer loan payments have reached a record of RUR 631 billion, or almost 12% of the total number of consumer loans and about 8,5% of the total volume. About 43% of the micro-loans are considered to be problem debts - Russians have servicing about 7 million micro-loans.

That kind of situation will sooner or later inevitably lead to social and political turbulence. However, it is hard to predict how exactly that would happen given the extreme mass repressions unseen since 1950s and the total destruction of political institutions, but two things are worth noting:

- After the annexation of Crimea in 2014, Putin's approval ratings have surged, but in subsequent years, began to deteriorate, and paved way for mass protests. It did not happen overnight, and the "Crimea euphoria" was holding on for some years - but the subsequent negative trend was nonetheless very clear, and the economic situation back then was not nearly as bad as it is now. These dynamics will be repeated again.

- In the past 40 years, Russian political regime has effectively changed twice on the background of economic downturn. First, it happened with the fall of the Soviet Union in late 1980s - early 1990s; the second time happened in 1999, when Russians, tired of the economic turmoil of the 1990s, have entrusted power to a person representing security apparatus (according to WCIOM poll of November 1999, 60% of Russians back then supported seizure of power by military or security structures to "restore order"). Political behavior of the Russians is not easy to predict, but they have not been known for easily forgiving their rulers economic troubles in the past decades.

Can Putin find a way forward for his economy?

So far, Russia’s best hopes in response to sanctions have been focused around three types of policies:

- Import substitution,
- Pivot to Asia, and
- Circumventing sanctions by increasing economic cooperation with non-Western countries.

Import substitutions have been tried years before and has limitations. Putin has built a highly monopolistic, corrupt economic environment, which is fundamentally not capable of innovation and client orientation, producing a competitive product. Many surveys of the results of food embargo imposed in 2014 against Western food and agricultural products suggest that their main results were growth in prices, decrease of quality of food, and emergence of state-backed monopolies like Miratorg which reap most of the benefits, to the disadvantage of the rest of the economy. The same is true for Rostech, a manufacturing and defense monopolist chaired by one of Putin's closest friends, Sergey Chemezov: multibillion investments over the years have yielded zero results in terms of technological breakthroughs, including the military sphere. Development of Russian CPUs as an alternative to Intel and AMD products has turned out to be a spectacular failure: for instance, Elbrus CPUs developed by MCST, a business arm of the Moscow Institute of Science and Technology, were tested at the end of 2021 by Sberbank and rejected, because they have met only 16 (!) of modern corporate requirements.

Pivot to Asia is working only partially for several reasons. The author has tried to explain this with the example of the not-so-successful Sino-Russian economic cooperation in 2014–2021 (see Vladimir Milov, "Ambitions Dashed: Why Sino-Russian Economic Cooperation Is Not Working", Wilfried Martens Centre for European Studies, November 2021). First, there is insufficient economic gravity: most of the population and economic activity in Russia is concentrated in the European part of the country, which is geographically part of Europe, and economic relations with Asia feature enormous logistical obstacles. Second, Asian economies are basically not interested in aiding Russian development and emergence of competitive high added value Russian products – the most of them substitute in using cheap Russian resources. The spectacular failure of the joint Sino-Russian project to develop a CR929 widebody aircraft is a typical example of this: China has forbidden Russians to market the jetliner inside China and has recently walked out of the project. Asian economies are also incomparable with Western economies in terms of size of financial assets, which can provide capital to Russian businesses: Asian investors mostly invest in or lend to projects which either promote their own exports of goods and services or guarantee access to cheap raw materials. There are more factors at play, but Asia will not be able to substitute the collective West as a provider of capital, technology, supplies of finished products and intermediary goods to a comparable extent.

The only thing that works relatively successfully now is efforts to circumvent the Western sanctions via countries that have not participated in them. The most substantial example here is probably Turkey. Since the beginning of Putin's aggression against Ukraine in February 2022, Russian imports from Turkey have increased by more than twofold, from roughly $500 million to about $1 billion per month, Turkey is providing Russia with some critical supplies of high-tech products, component parts and other items that Russia can no longer access in the West due to sanctions. Many other countries are also helping Russia to circumvent the sanctions: China, Central Asian countries, Israel, United Arab Emirates, Serbia, etc. This problem should be seriously addressed by the West, but it will not be able to solve Putin's problems in the long run.

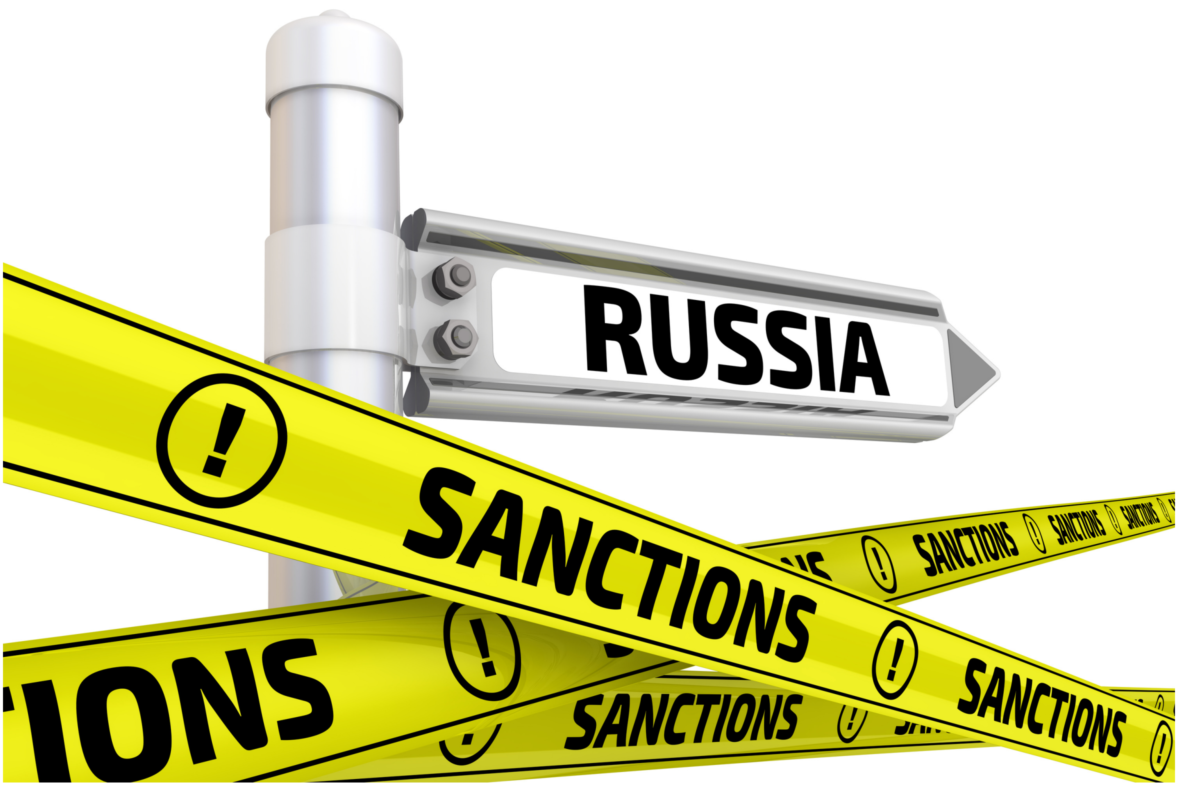
It is also worth noting in this regard that the EU does not have a full-staffed and equipped specialized agency aimed at monitoring compliance with sanctions, which makes circumvention of sanctions a relatively easy job. Such a specialized agency (an analogue of the U.S. OFAC, Office of Foreign Assets Control, but better staffed and equipped) is an absolute necessity.

Conclusions

As explained above, an analysis of the effects of Western sanctions on the Russian economy should not be left to a superficial lightweight "analysis" of a narrow set of largely manipulated or misleading macroeconomic indicators. The more complex cross-sectoral analysis of the Russian economy suggests that the impact of sanctions is broad and long-lasting, with a significant potential to increase over time. Putin's search for lifelines like import substitution, pivot to Asia and circumvention of the sanctions can only produce limited effects. Russia will inevitably be facing serious social and political implications of the economic difficulties inflicted by sanctions.

Some of the key policy recommendations here include:

- Exercising strategic patience when it comes to the effects of sanctions on the Russian economy. Sanctions need time to produce the most comprehensive effects.
- Developing a detailed set of indicators that reflect the status of the Russian economy realistically to monitor the actual effects of sanctions.
- Dropping the practice of judgment on the effectiveness of sanctions by a limited set of macro indicators which are misleading and manipulative.
- Considering attempts to persuade the public that "sanctions are not working" based on just a few macro indicators (GDP, unemployment, ruble exchange rate, etc.) as a part of Putin's disinformation campaign.
- Working with non-Western countries which are currently helping Russia to circumvent sanctions, to make sure such practice stops.
- In this regard, the EU needs to seriously consider establishment of a full-staffed and equipped specialized agency aimed at monitoring compliance with sanctions, an analogue of the U.S. OFAC (Office of Foreign Assets Control), but better staffed and equipped.



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