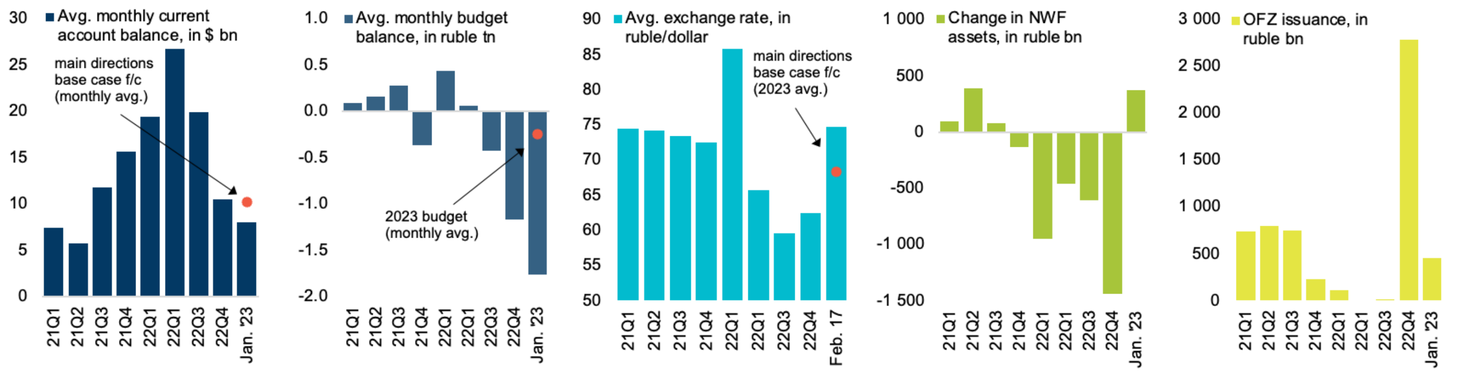
ONE YEAR OF SANCTIONS: KEY MESSAGES

Prepared by the KSE Institute Sanctions Team, February 24th, 2023

Growing impact of sanctions. *KSE Institute* sees clear evidence that sanctions are putting increasing strain on Russia's economy, trade dynamics, and government finances – in particular as oil sanctions have come into force and European purchases of Russian gas collapsed. The country is approaching a turning point in 2023 – and additional measures by Ukraine's allies could exacerbate Russia's fragilities, and accelerate victory.

Macro picture worsening across the board. *KSE Institute* observes increasing stress on multiple dimensions: Russia's trade surplus is falling on the back of sharply lower oil and gas earnings; the budget deficit continues to widen, which accelerates withdrawals from the oil fund and drives up domestic borrowing; and the ruble has come under renewed pressure. Painful policy choices loom.



Deepening Recession

Recession to deepen this year. *KSE Institute* believes that official statistics – which show a 2.1% drop in real GDP for 2022 – conceal the true damage to Russia's economy from the war and sanctions. Importantly, a much less supportive external environment will no longer be able to offset weak domestic demand this year, leading to a contraction of 5-6% in our baseline scenario – and a bigger drop if sanctions are tightened.

War economy is propping up activity. Weapons manufacturing is supporting Russia's industrial sector while the overall economy is benefiting from state aid and import substitution. But effects of sanctions will intensify as producers deplete inventories of critical imported inputs and circumventing sanctions drives up costs. Importantly, industries with the highest rents (e.g., oil and gas) and/or growth potential are the hardest hit.[1]

Dim medium- and long-term outlook. Russia has lost access to its traditional sources of FDI and not found alternative ones – potentially one of the most impactful consequences of the war. At the same time, negative sentiment weighs on domestic investment, and the government is cutting investment to pay for the war. Unfavorable demographics, the departure of skilled workers, and anemic productivity growth also do not help.[2]

Collapsing Oil and Gas Earnings

Record surplus last year due to soaring energy prices and weak imports. Russian exports reached $540 bn last year – a 10% increase vs. 2021 – driven by an all-time high $350 bn in oil and gas earnings. Higher prices more than offset lower volumes as the EU and other allies of Ukraine stopped buying Russian energy. Russia was also able to reroute oil from traditional markets to countries such as India, China, and Turkey.

But this year the surplus will collapse, as sanctions bite. Last year's record-high current account surplus ($227 bn) conceals strengthening headwinds. The surplus already fell by 60% between Q2 and Q4 – and December/January data indicates growing weakness. *KSE Institute* expects a current account surplus of ~$70 bn for 2023, driven by a shrinking trade balance, with risks clearly to the downside.

Falling oil and gas exports are the critical factor. Russia's trade - and beyond that the economy and the budget - have always been driven by oil and gas. This time is no different. Sanctions were implemented only

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[1] See Becerra (2023), Grozovski (2022), Milov (2022), Rácz et. al. (2023), and Simola (2022)

[2] See Grozovski (2022), and Simola (2022)

gradually in 2022, but they are beginning to bite. With the EU embargo and G7 price caps now in place, *KSE Institute* projects oil and gas earnings will drop by ~50% this year. And Russia could lose another $50 bn if the oil price cap is ratcheted lower to $30/bbl, as we propose.

Loss of European market proves costly. The war and Russia's attempts to weaponize energy backfired. The EU embargo on crude has sharply reduced demand for shipments from Baltic Sea ports – and Russia is selling at huge discounts to "new" buyers to keep up volumes. For gas, the largest and most lucrative market is gone for good. The IEA estimates that the loss of the European energy market will cost Russia $1 tn by 2030.

Growing Deficits and Financing Challenges

Fiscal pressure is rising – budget deficit will widen in 2023-24. Russia finished 2022 with a deficit of 3.3 tn rubles (2.1% of GDP) – a shift of close to 5 tn vs. pre-war plans –, and reported a record deficit of ~1.8 tn in January. With oil and gas revenues set to drop sharply, *KSE Institute* forecasts a further widening – to 5-6% of GDP on current policies and to 7-9% of GDP should the price cap be lowered and energy sanctions tightened.

Constraints on raising revenues. Last year, corporate profits rose, helped by soaring commodity prices, and the authorities were able to tap Gazprom for 1.8 tn rubles in dividends and a special tax. The Russian MinFin estimates that recent changes to the benchmark tax oil price – and new company taxes and fines – will generate 1.1 tn rubles in extra revenue. But this is optimistic, given a depressed economy and lower energy prices. In fact, revenues are heavily underperforming, with Russian oil selling for $50/bbl, where the budget assumes $70/bbl.

Heavy reliance on the NWF will deplete buffers quickly. Russia used its oil fund to finance the growing deficit and support struggling companies in 2022 – to the tune of 3.7 tn rubles (~$53 bn). As a result, the NWF shrank by 25% to 10.4 tn (7.8% of GDP) by the end of 2022 and will likely run out of liquid funds sometime in 2023. Importantly, authorities sold off most of the fund's high-quality assets in 2022H2, leaving largely gold and yuan.

High domestic borrowing puts pressure on banks. Russia's MinFin issued a record 2.8 tn rubles (~$47 bn) in domestic debt (OFZ) in 2022Q4. And with foreigners largely gone from the market this means that domestic banks will have to buy the debt, which is putting upward pressure on rates and pushing up the cost of servicing debt. MinFin's failure to attract acceptable bids at the Feb. 22 auction is a sign of growing financing challenges.

Government faces pressure to cut spending, raise taxes. As deficits rise, the oil fund is consumed, and debt issuance becomes costlier, Russia will have to choose between fiscal consolidation – cutting spending and hiking taxes – or rising inflation and financial stability risks. In the past, Russia has acted to consolidate public finances in crises – but that will constrain conduct of the war, so they will likely take more risk this time.

Financial Fragilities Reemerge

Return of a weaker ruble. The weaker current account has driven a sharp fall in the ruble (20% since Nov.). This helps on fiscal as earnings from oil and gas increase in ruble terms - for instance, we estimate that the current level of 75 RUB/USD (vs. 68 in the budget) is worth ~1 tn rubles in additional revenues. But a weaker RUB poses rising risks for inflation – with import prices rising – and financial stability – as it triggers demands for liquidity.

Further measures could exacerbate Russia's fragility. Cutting the oil price cap from the current $60/bbl to $30/bbl would, if properly enforced, cost Russia another $50 bn, and exacerbate existing vulnerabilities – essentially eliminating the current account surplus, widening the deficit, weakening the currency, and putting Russia into a constrained and fragile economic situation – thereby helping to accelerate the end of the war.

Tighter policies and rising tensions. With a weakening ruble and growing deficit, tighter policies are needed to stabilize the economy and persuade banks to buy debt. Given the government's priorities of funding the war while avoiding social spending cuts, monetary policy will have to do more work. *KSE Institute* expects 300-400 bps in interest rate hikes in 2023H1 – and growing tension between the CBR and government.

War and Sanctions Hit Labor Market, Incomes

Official data is hiding trouble in the labor market. Authorities are reporting a record-low unemployment rate of 3.7%. But estimates of hidden unemployment, including reduced work hours and unpaid leave, range around

13% – a sharp uptick vs. the pre-war period, especially in manufacturing. This is despite the fact that 700k-1mn left the country and mobilization took hundreds of thousands more out of the labor force.[3]

War is making Russians poorer. Even official data points to falling real wages and incomes, but the true impact is likely much bigger. Sharply lower retail sales and decreasing savings point in this direction – while consumer sentiment took a significant hit at the time of mobilization in the fall. Harder to measure, but not less important, is the departure of many foreign brands and declining quality of domestic products due to missing inputs.[4]

Noticeable Sectoral Impact

Military production hit by sanctions but enforcement is key. Export controls by Ukraine's allies have had a noticeable impact on Russia's ability to produce military equipment – with important implications for the war. However, producers can rely on significant stocks of components; and Russia seems to be able to acquire inputs from countries such as China. Thus, strengthening of the sanctions regime, and vigorous enforcement is critical.

Transportation system under strain. Russia is keeping its aviation sector afloat by cannibalizing some planes and extending maintenance intervals when replacement parts are no longer available for equipment that is either foreign-made (70-80% of the fleet) or contains critical foreign-made components. Imports from alternative suppliers (e.g., China) cannot compensate, and the situation will inevitably deteriorate further.

Coal sector impacted by embargo. Often overlooked due to the outsized role of oil and gas, coal exports dropped by 6.8% in 2022. Higher domestic consumption offset some of this. The loss of the European market is hitting several major coal regions hard, while reorientation to alternative customers in Asia drives up costs and puts strain on the railway infrastructure. Important producers are now struggling with profitability.

Gold exports drop. International sanctions on gold led to a sharp drop in exports in 2022H2. However, purchases by Russians increased roughly tenfold as the economy slid into recession and uncertainty spread – and exports to "friendly" countries such China, Turkey, and the UAE rose. Nonetheless, disruptions to the supply of spare parts and equipment has led some producers to cut output.

Struggling with export redirection. Energy is not the only area where the loss of traditional export markets is creating challenges for Russian companies. We observe similar developments in mining of metallurgical ores (production -4.5% in 2022) and steel production (-10%). China is buying more, but reports from MMK, NLMK, and Severstal indicate that it may not be enough. Wood processing also experienced a 12.5% drop last year.

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[3] See Milov (2022)
[4] See Milov (2022)