Beyond the Headlines:

The Real Impact of Western Sanctions on Russia

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Credits

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Beyond the headlines: the real impact of Western sanctions on Russia

There has been much ongoing debate about the effects of economic sanctions imposed on Russia since the beginning of Putin's war against Ukraine. Many commentators argue that sanctions are having only limited effects or no effect at all - firstly, because they haven't forced Putin to change his policies, and secondly, because the Russian economy has demonstrated significant resilience. This paper argues that both assertions are misleading. The latter argument - about the resilience of the Russian economy - is based on a flawed approach focused on just a handful of macroeconomic indicators, which are insufficient to assess the genuine state of the Russian economy. A consideration of more detailed data is necessary to determine the true effect of sanctions. Once that is done, the former argument also collapses: the reason Putin hasn't changed his policies yet is because the Russian economy has some significant safety margins (most likely specifically developed to withstand the consequences of an aggression against Ukraine), and it takes time for sanctions to produce visible macroeconomic effects, thereby forcing Putin to change his policies.

This paper provides an in-depth analysis of a wide array of detailed economic data, which suggests that such effects are on the way. A look beyond a limited number of widely discussed macroeconomic parameters proves that the economy is already experiencing a wide range of unprecedented difficulties, which are only being contained by policy tricks and Russia's remaining financial reserves. It is important to understand this comprehensive picture of the effects of sanctions, in order to make adequate policy judgments as to their efficiency.

I. How to measure the effects of sanctions?

The common knowledge about the impact of Western sanctions on Russia is that Russian macroeconomic indicators show only modest economic contraction: according to official data, GDP has declined only by 2% in annual terms after nine months of 2022, the federal budget has shown a surplus until at least the end of September, and the ruble has nominally strengthened at the Moscow Stock Exchange. But does it make sense to focus on these indicators?

At closer glance, probably not. The statistical data that is still available (after the Government began concealing data since the beginning of the war) shows a much deeper economic contraction than official GDP figures, which must be seriously distorted by the surge in military spending and manufacturing (according to the recently introduced amendments to the federal budget, military spending in 2022 is supposed to be 33% higher than forecast in the original 2022 budget approved last December). Budgetary surplus was accumulated during the first months of growth in oil prices at the beginning of the war - but since early Summer, this growth has largely eroded, and the budget is moving into a widening deficit territory. The ruble has nominally strengthened, but only as a result of draconian measures by the Central Bank which have de facto destroyed the ruble's free convertibility, achieved over the past 30 years – and a 'strong' ruble produces very negative effects on the budget and exporters, consequences widely recognised by Government officials.

Although the Government and the Central Bank have concealed much statistical data about the Russian economy since February (which is in itself a strong indicator that the Russian economy is in a much worse state than Putin cares to admit), there are a number of relatively reliable indicators still being officially reported, which reveal the true, much worse state of affairs in the Russian economy. The key figure to watch in this regard is probably the non-oil & gas revenue of the Russian federal budget (NOGR) - all taxes and revenues that are not related to oil & gas exports. The most important components of NOGR are proceeds from VAT and the federal portion of the corporate profit tax (over 70% of NOGR).

NOGR is not only a valuable indicator of actual economic activity, but is also very indicative in terms of financial and operational difficulties experienced by enterprises. The Russian business climate in previous years was notorious for the tax revenue service putting excessive pressure on enterprises, boasting about the 'effectiveness' of measures aimed at the 'improvement of tax collection administration' – the growth in tax revenue always exceeded GDP growth in the past few years, due to the permanent imposition of excessive tax claims on businesses. Many businesspeople faced criminal prosecution and even jail time for 'tax evasion'. On this backdrop, it can be reasonably assumed that delaying tax payments and facing the risk of prosecution is probably one of the last things a businessperson will do in the current Russian environment, and that such deferred tax payments are a result of collapsing revenues and an absolutely dire financial situation which leaves no other choice but to reduce tax payments to the state.

According to figures provided by Russian Ministry of Finance, the total non-oil & gas federal revenues were down 4,3% over a 9-month period of 2022, as compared to the same 9-month period of 2021. In 2021 and 2020, NOGR grew by 15,8% and 15,3% year-on-year respectively (while GDP grew by 4,7% in 2021 and declined by 2,7% in 2020). The contraction of non-oil & gas revenue suggests that the contraction of economic activity is much more significant than the modest 1,5% decline in GDP officially reported for the first 8 months of 2022.

Other indicators leading to similar conclusions include the collapse of retail trade and transport turnover. Retail trade plunged by 9,8% year-on-year in April and hasn't really improved since - in July-August, it was down almost 9% year-on-year. In early October, Vladimir Putin publicly complained that retail trade has plunged further since military mobilisation was announced on September 21st. Transport turnover has declined by 1-2% year-on-year in April-May, but the annualised decline worsened to 4-5% by July-August, and to over 7% by September. Rosstat still provides detailed data for output by various extractive and manufacturing industries, and output contraction in some of them is quite spectacular (more details on that provided below). If these detailed figures are taken into account, a much grimmer picture of economic contraction emerges.

II. Effects of sanctions on various sectors of the economy

A cross-examination of the effects of sanctions on various sectors of the Russian economy suggests that their impact will be much more serious than anticipated by most observers, long-term, widespread across sectors and markets, and will produce a number of profound impacts which are currently only contained by temporary factors. In future months and years, in parallel with the exhaustion of Russia's reserve potential to contain these negative effects, the economy will continue to sink - perhaps at a slower pace than some had anticipated, but the trend is clear and irreversible. Here is a wide look across sectors, which illustrates the systemic problems which sanctions have created for the Russian economy.

The collapse of manufacturing industries

One of the key effects of sanctions is the collapse of some of the most important manufacturing industries, which are critically dependent on Western technologies and components that have largely gone without satisfactory replacement. The pattern here is that the most complex sectors with high employment are suffering the most - while those sectors that somehow benefited due to import substitution are more ‘primitive’, and especially do not rely on a skilled workforce nearly as much.

While in the war’s opening months, Russian industries showed a relatively modest contraction, in September, the picture became much clearer – the decline of industrial output year-on-year reached 3,1%, the worst drop since the peak of COVID-19 pandemic in Spring 2020. Ironically, this data was published just about three weeks after Vladimir Putin boasted about industrial output “recovering to pre-war levels” at a meeting with his economic ministers on 7 October, as one of the key achievements of the Russian government in response to sanctions. While extractive industries contracted by just 1,8%, the worst hit was suffered by the manufacturing industries - which contracted by 4% in December. Rosstat data shows that the trend here is clearly negative - industrial contraction in Q3 2022 was worse than in Q2.

A specific breakdown by particular manufacturing industries (the figures below are derived from the Rosstat publication referenced above) shows that the industries that have suffered the worst are the most complex, requiring significant international cooperation in technologies and the supply of spare parts. There has been much discussion on the collapse of the Russian automobile industry, where output in September was down 77,4% year-on-year. It should also be noted that the carmaker industry is extremely labour-intensive: according to Russian government estimates, it generates 3,5 million jobs directly and in allied industries supplying products and component parts for carmakers. The future of the Russian automobile industry should be the subject of a separate analysis, but in short, it doesn’t have any real prospects to rebuild beyond current, stagnant numbers.

But it doesn’t just stop at carmakers; in September 2022, manufacturing of railway locomotives was down by 20-30% year-on-year; railway cargo coaches by 32%,%; bodies for motor vehicles by 44%,%; cargo transport vehicles by 34%,%; buses weighing below 5 tons by 51% (above 5 tons by 21%),%); internal combustion engines by 37%,%; lead batteries by 10%,%; centrifugal pumps by 26,5%,%; washing machines by 58%,%; television sets by 50%,%; refrigerators by 42%,%; semiconductor devices and their parts by 24,5%,%; power transformers by 23%; fibre optic cables by 20%,%; bulldozers by 20%,%; sowing machines by 15%,%; and the list goes on.

It shall be noted that these sectors are also quite labour-intensive - for instance, transport machinery manufacturing accounts for over 200,000 jobs alone, according to the government's estimates. Admittedly, growth has been recorded in some manufacturing sectors, due to some amount of import substitution – for instance, food (2% growth year-on-year in September), drinks and tobacco (4% each), clothing (6%), paper (2%), and pharmaceuticals (12%). However, as clearly shown by these numbers, this is insufficient to reverse the overall picture of decline – in addition, sectors like food, tobacco and pharmaceuticals are far less complex than other manufacturing industries such as car-making, transport machine building, engine-building, etc. The impact on employment of these difficulties are analysed below in more detail.

Real troubles for extractive industries

While enjoying some benefits due to rising energy prices at the start of the war, extractive industries have begun to experience significant hardship in recent months. The most significant impact of the standoff with the West has been seen in the natural gas industry - gas exports have collapsed by more than 40% year-on-year in July-September, and gas output has fallen by 26%, as per Rosstat. This is the result of Putin's voluntary boycott of gas supplies to Europe since the Summer. The collapse of gas exports has resulted in a decline of total oil & gas revenues for the Russian federal budget in July-September as compared to the relevant months of 2021 - even despite the fact that the Urals oil price was about 10% higher than during similar months of 2021. In September, total oil & gas revenues were down 4,5% year-on-year.

The strategic problem with the collapse of natural gas exports and revenues is that there is no clear way to restore them - particularly after the explosions of the Nord Stream-1 and Nord Stream-2 pipelines, with Europeans putting the blame squarely on deliberate acts of Russian sabotage. Together with earlier unilateral near-complete cut-off of gas supplies to Europe by Gazprom, these developments have destroyed Russia's reputation as a reliable supplier of gas, and Europe has managed to find alternative suppliers. It is very hard to imagine a scenario under which significant gas supplies from Russia to Europe shall be restored, even if one imagines that the war ends tomorrow. The infrastructure allowing exports of gas to Asia from the main Russian gas-producing region, Western Siberia, simply doesn't exist - building it will be a lengthy and costly effort. While studying the viability of such efforts is a separate subject of analysis, one thing is clear - given the enormous costs and tight pricing policy of China and India vis-a-vis Russian suppliers, it is highly unlikely that Russia might draw significant profits from gas supplies to Asia, and certainly not comparable to the income it enjoyed from European markets in past decades.

Russian oil production and exports were relatively stable until recently, but the worst is yet to come: a European crude oil embargo is due to come into effect in December 2022, and a refined products embargo in February 2023. Russia will remain able to divert some of its oil exports to Asia, but this will come at higher costs for Russia and steep discounts for buyers - see below in more detail.

Another major export-oriented energy industry that faces severe output and exports contraction is coal production. The European embargo on Russian coal became effective in August 2022, and the re-direction of coal exports to Asia had limited or no effect: the saturated market failed to accommodate new Russian coal volumes. Since the beginning of the year, Russian coal exports have contracted by about 9%. In August 2022, hard coal production (except coking coal) fell by 13,5%, and anthracite by 25%, year-on-year. Troubles experienced by the coal industry will only exacerbate further, as the European coal embargo takes its toll. Here again, the coal industry is quite labour-intensive, particularly in the main coal-producing regions like Kuzbass (Kemerovo), where it is the main source of regional income, and generates around 100,000 jobs in the Kemerovo region alone.

Steelmakers under pressure

The steelmaking industry is suffering various troubles from different directions - sanctions, the contraction of domestic demand (the aforementioned manufacturing industries are key consumers of its products), weak Asian prices, plus an artificially strengthened ruble which kills the profitability of exports. Indeed, the steelmaking industry is one of the key sectors suffering from excessive strengthening of the ruble. Both the World Steel Association and the Russian government forecast approximately a 9% contraction in Russian steel demand this year, and the possible production decline in 2022 is estimated to be up to 15%. According to Rosstat, steel production was down by 2,4% year-on-year in September, while finished metal products were down 5,4%.

The ferrous metals industry is, as the others, labour-intensive: over 400,000 direct jobs, plus over 2 million people in allied industries depend on orders from steelmakers. The troubles of the Russian steelmaking sector will have a severe impact on the Russian job market and incomes further down the road.

A looming banking crisis

It is only logical to expect that, on a background of serious contraction of economic activity, especially severe in certain industries, Russian banks will experience difficulties with borrowers and a deteriorating quality of corporate credit portfolio. This is the exact reason why the Russian Central Bank has ordered banks to cease publishing their financial accounting immediately after the war began.

Without published accounts, it is impossible to assess the looming problems in the banking sector - but, in any case, these problems can't be avoided. The experience of several previous economic crises since 2008 prove that banks are inevitably affected by the economic woes of their borrowers - and this time, the crisis looks far more severe than any other in the past decade and a half. The experience of collapse of the top 10 private banks in 2017 (including Otkrytie, MKB, Binbank) show that the Russian Central Bank is inclined to hide the extent of problems within the banking system until they require immediate intervention; it is impossible not to expect problems in the banking sector given the current level of decline in economic activity. Some of the comments made by top bankers suggest that major problems are well underway – see, for instance, a recent interview by the CEO of "Trust" bank Alexander Sokolov to the "Kommersant" newspaper (his bank is ranked 15th in Russia in total assets) titled "Easier to list those [clients] who do not generate difficulties" - a very telling phrase in itself. Developments in the banking sector should be monitored closely.

Collapsing imports

One of the key consequences of sanctions was the collapse of imports. The Russian Government immediately classified export-import statistics in March, but, according to some estimates by Russian officials, in Spring, imports fell by as much as 70% year-on-year; as estimated by the Russian Customs Service in October 2022, imports had fallen by 65-75% year-on-year . The collapse in imports hurts both the supply side – i.e., critical investments and intermediary goods for manufacturing, transport, communications, and the services sectors - as well as demand: Russians lose access to price-competitive and high-quality consumer goods. A drop in imports has contributed both to inflation and to the deteriorating quality of life for everyday Russians (see below for more details). As of October, the Russian Customs Service estimates that imports of critical (irreplaceable) goods stands at 11-12% - enough to cause major disruption to the manufacturing and services sectors. Imports of lower quality substitutes for lost Western products and intermediary goods also decrease productivity in the longer run.

It should also be noted that disruption to imports have just begun, as many sanctions introduced against Russia in the Spring contained waivers honouring existing contracts, and many new sanctions continued to be introduced in the following months.

Russia was able to substitute some of the lost import volumes through parallel imports and circumvention of sanctions through third countries, but not much - just below 10%, as estimated by the government. Parallel imports are complicated, unreliable, create additional costs, and can only partially substitute lost volumes of imports. The known cases of parallel imports also contribute to inflation, because purchasing and logistical costs are significantly higher (as reported by Forbes Russia, sometimes increasing the end price by 250-300%). Sanctions circumvention works - which is a major problem at the moment – but that also cannot fully substitute lost imports from Western countries.

Inflation

As a result of supply disruptions and the collapse of imports since the beginning of the war, annualised inflation peaked at 17,8% in April 2022 (from around 9% in January-February) - the highest level since 2001. In the following months, the government had boasted about inflation "receding" and paving the way for deflation - but that process had effectively stopped and reversed in September, with annualised inflation bottoming out at an average of 13,7% - not much of a decline compared to April, and still significantly higher than pre-war levels. Growing fiscal spending and reliance on the National Wealth Fund to finance the budget deficit, the growing costs of imports, and supply disruptions caused by Putin's mobilisation (as recently officially admitted by the Russian Central Bank) will all serve as significant pro-inflationary factors in the near future.

Inflation is the key factor that will keep real incomes in negative territory: neither the government nor businesses have enough money to keep wages and pensions indexed to the current record levels of inflation. Average wage indexation in January-August 2022, according to

Rosstat, was just 12,7%; the currently adopted federal budget for 2023 envisages indexation of social benefits by only just over 12%.

It should also be noted that inflation in Russia is, in all likelihood, severely underreported. There are two reasons for this. First, many widely available investigative media reports on price monitoring over the years show that Rosstat systemically underreports the growth in prices for basic products. Second, Rosstat accounts food as just 37-38% of its average consumer basket used to calculate inflation, whereas many consumer surveys indicate that the average share of food in the consumer basket of Russian people is about 50% or higher. Food inflation is higher than growth in consumer prices of other goods, which even Rosstat recognises.

The fact that prices haven't followed the spectacular "strengthening" of the ruble at the Moscow Stock Exchange also indicate that the current ruble exchange rate is just another Potemkin indicator that bears little relevance to reality. While the U.S. dollar had lost over 50% of its value to the ruble by early November since mid-March, consumer prices, as shown above, have not receded nowhere nearly accordingly, indicating the actual growth of costs of those goods still being imported. (In the 2000s, inflation receded accordingly when the freely convertible ruble had strengthened.)

Adverse effects of the nominal strengthening of the ruble

One of the major arguments made by those arguing that sanctions against Russia have little or no effect is the nominal strengthening of the ruble. However, this is hardly a serious discussion. Since the beginning of the war, the Russian Central Bank had introduced draconian currency controls, de facto eliminating the ruble's free convertibility. As the Wall Street Journal put it, the ruble is in "a central-bank-induced coma." The nominal strengthening of the ruble is the flip side of collapsing imports, which, as explained above, has very strong negative consequences for the economy and living standards of Russians. In fact, an over-strengthened ruble has zero positive effects for the economy, but a lot of very strong negative effects - primarily on the competitiveness of Russian exporters, who are struggling against growing ruble-nominated costs and receive far less money for their products in rubles. The steelmaking industry mentioned above is one of the key areas affected; generally, the Russian government admits that the effects of a strengthening ruble on the economy are largely negative, and intends to weaken the national currency further down the road - but it is clearly afraid of doing so for political reasons, maintaining the facade of a "resilient economy weathering the sanctions" with an artificial ruble rate.

The artificial strengthening of the ruble is already felt by non-energy exporters: as admitted by the Russian Customs Service, by October, non-energy exports (manufactured products, steel, chemicals, food) fell by 13% year-on-year, and by the end of 2022, will fall by 17%, according to the government's estimates. This is only a partial result of sanctions - among the key buyers of Russian non-energy goods were China, Kazakhstan, Belarus, and Turkey. It is clear that some of the decline of non-energy exports can be attributed to a loss of competitiveness because of the nominal strengthening of the ruble.

Disruptions in digital infrastructure

The Russian digital infrastructure is extremely dependent on Western technologies, hardware and component parts - and it is also critical for the functioning of the large-scale modern economy. There are a wide array of problems across the board - from a critical deficit of server capacity to video cards, hard drives, cases and processors, to critical telecommunications equipment. The market of used components for laptops and computers has grown two to fourfold in the first 9 months of 2022. Plans of expanding and even maintaining current 4G networks or expanding broadband and internet are severely hurt by sanctions and the departure of key hardware suppliers from the Russian market. Russian banks are unable to update ATM software, and many other issues persist in the digital sphere.

Troubles with digital infrastructure are one of the most severe problems caused by sanctions and threaten serious disruption to the operations of top Russian state agencies, corporations, and banks.

Agriculture

The agricultural sector is doing slightly better than most sectors of the Russian economy due to a record grain harvest and some effects of import substitution. But, apart from the grain harvest, the situation also doesn't look too bright, and sanctions may be very disruptive in the future. While grain threshing is up 35% year-on-year on October 1st, 2022, harvesting of sugar beet is down 11%, and sunflower is down by 56%. The growth in production of meat, dairy, and eggs is up by a modest 2-3%.

A record grain harvest on the backdrop of international sanctions, difficulties with logistics, and restrictive measures by the Russian government has made agricultural producers rather unhappy: they complain of record low prices at domestic grain markets, which may eventually lead to the collapse of many grain producers. Russian harvesting is also extremely dependent on the imported seed bank: while for wheat this dependence is only within the 10-15% range, it is over 20% for barley, 45-55% for soya and corn, 65-75% for potatoes and sunflower, and 97% for sugar beet. This may be a longer term problem for the Russian agricultural sector, but a much more pressing issue is the lack of spare parts for agricultural machinery, which affects about 30-40% of the total agricultural machinery park.

Contraction of consumer demand and incomes

The Russian government only reports a near-zero contraction of real wages and pensions since the beginning of the war (-1,5% contraction in real wages and -2,6% in real pensions after 9 months of 2022 as per Rosstat), but such reports are most likely based on underreported inflation (as mentioned above), and simply do not match the official data on a sharp contraction of consumer demand.

According to Rosstat, retail sales fell by about 9% year-on-year since April, and failed to rebound since; in early October, Vladimir Putin has admitted that weak consumer demand is a major problem for the economy, and that retail sales accelerated the plunge since military mobilisation was announced on September 21st. In September 2022, Rosstat reported an annualised contraction of retail sales by 10%. This data is supported by many other verifiable merits - traffic in commercial centres, the financial data of retail market players, etc.

It is simply impossible that real wages and incomes of Russians fell only within the 1 to 2% range, knowing that domestic sales plunged by 10%. Savings have also plummeted: according to an October survey by the Russian Public Opinion Research Center (VCIOM), 21% of Russians have reported a contraction of their savings since the beginning of the war, while savings have grown only for 5% of those surveyed (39% stated that the amount of their savings hasn’t changed, and 34% didn’t have any either before or now). Retail sales is arguably the most important indicator showing that the actual contraction of living standards for Russians is much higher than officially reported figures.

Businesses indicate a lack of sufficient domestic demand as a key impediment to their operations; if demand does not rebound (and there are no objective prerequisites for that), producers will inevitably have to reduce output and lay off employees. Domestic demand sharply deteriorated after Putin announced military mobilisation on September 21st.

The economic impact of military mobilisation

The military mobilisation announced by Putin in September produced several key effects on the economy: a sharp contraction of demand, a spiking deficit of skilled workforce, and large-scale cash withdrawals from banks by the population. All of these effects have the strong potential to further depress economic activity, as was even publicly recognised by the Russian Central Bank in October.

The deficit of skilled workers was always seen by Russian businesses as one of the main factors impeding business development; after mobilisation was announced, the situation spiralled out of control. According to the official Russian Economic Ministry estimates, in October alone, the Russian workforce suddenly decreased by 600,000 people - these people have either been drafted or left the country. The estimate is that the people that were drafted or left Russia represent the most qualified workforce: first, because the offices of large companies faced organised on-site drafting campaigns, and second, because skilled personnel have the financial means to leave the country (unlike lower-skilled workers with less pay). More complex industries will face deeper problems because of mobilisation, which is supposed to last; the Russian Central Bank has openly recognised the negative future effect of mobilisation on the supply side.

Then we must consider the further collapse of sales: apart from problems on the supply side, business will face sharply contracting demand. As mentioned above, retail sales plunged further since mobilisation was announced, as openly recognised by Putin. Traffic in commercial centres contracted by about 20% after the announcement. Obviously, Russians now have more existential things to do than shopping. The other important consequence is that, following the mobilisation, Russians rushed to withdraw cash from banks at a significantly greater pace, which forced banks to raise interest rates, in contrast with the Central Bank's rate reduction. On that topic, the Central Bank stopped lowering the interest rate further in October, specifically citing mobilisation as bearing pro-inflationary risks. Putin's mobilisation decision has put many brakes on any prospect of economic recovery -

curbing supply and demand, creating additional inflationary expectations, and forcing the Central Bank to reconsider further interest rate cuts.

The budget deficit: how much money is left for the Russian state?

A sharp rise of international oil prices since the war began has given the Russian budget a boost: by the end of May, it had accumulated a surplus of around RUR 1,5 trillion (There are no estimates in dollars or euros here, as the effective convertible exchange rate is not known since the ruble's convertibility was effectively terminated by the Russian Central Bank in March; what matters for the budget is the balance between revenues and spending in actual rubles). But that surplus was effectively eroded by the end of September due to declining oil & gas and non-oil & gas tax revenues, as well as increased spending. The Government admits that this year will see a budget deficit of 0,9% GDP or higher, and has already untapped the state's financial reserves to finance the deficit.

So how much money is left in Putin's pockets? When a deficit occurs, all eyes usually turn to the Government's rainy day fund, the National Wealth Fund (NWF). These are the funds kept in the Russian Finance Ministry's accounts in the Central Bank - effectively, these are excess revenues from oil & gas exports accumulated over previous years. Although technically part of the Central Bank's monetary reserves, the NWF funds were not frozen as part of Western efforts to freeze the Central Bank's assets, and remain intact and available for use by the Government.

Currently, the NWF has accumulated 10,8 trillion rubles as of October 1st, 2022 (down from RUR 13,6 trillion on February 1st); but, according to the Russian Ministry of Finance, only RUR 7,5 trillion of these are "liquidity funds" - actual cash. The rest is invested in shares, bonds and other financial instruments of large Russian state corporations and banks, and therefore cannot be swiftly recovered.

Given the pace of erosion of the budget surplus in June-September 2022, it can be assumed that the "high liquidity" portion of the NWF funds may be spent in about a year and a half (roughly RUR 1-1,5 trillion per quarter). But, as the EU oil embargo comes into effect, the budget deficit will probably grow larger, which will require a faster pace of NWF spending in order to finance the deficit. As the NWF is spent, the Government will face the grim prospect of switching to monetary emission to finance its budgetary needs - which risks sparking inflation. In fact, this process has already begun - in September, the short-lived deflation stopped after five months and reversed towards price growth again, as described above. However, one should bear in mind that technically speaking, releasing a significant amount of NWF money into the economy is not much different from monetary emission, and will support rising inflation.

Budgetary and spending constraints also do not allow Putin to significantly increase the amount of money allocated to finance the war. The federal budget for 2022-2024 submitted by the Government to the State Duma (which will most likely be adopted with only minor changes) envisages an increase of total military spending (including the classified portions of the military budget) from about 3,5 trillion rubles per year as approved before the war to about 5 trillion rubles per year. That is absolutely insufficient to ensure financing of all wartime needs, including the newly mobilised army that Putin promised to finance on the same level as military contract servicemen. The 300,000-strong newly mobilised force is about the same size as all the contract servicemen in the army before the war. Given the extent of combat operations, Putin probably would have needed to increase military spending to RUR 10-15 trillion per year to provide sufficient financing for his military operations - but he simply can't afford that, given budgetary constraints.

III. Social and possible political impacts of sanctions

It is important to note that Putin's popularity, which determined his political supremacy, was built on the high level of economic growth during his first two terms in office. In 2000-2008, before the 2008 financial crisis broke out, Russian GDP was growing by an average of 7% per year, and real disposable incomes of Russians by over 12% in average. Since then, Putin's approval gradually fell, and he was only able to revive it with foreign policy adventures like the annexation of Crimea in 2014 (which also faded sometime afterwards), and all-out aggression against Ukraine and the West in 2022. The inability to sustain the economic well-being of Russians will backfire on Putin in the future.

Key problems caused by the sanctions are looming unemployment, declining consumer purchasing power, and declining living standards. This is happening on an unprecedented scale, despite the Russian government's attempts to hide the real picture behind the facade of a handful of satisfactory nominal indicators. Unemployment in this regard is the most interesting indicator: while the nominal unemployment figures are artificially kept at record lows, there's an unprecedented level of hidden de-facto unemployment that is taking place at the moment.

Looming unemployment

So far, Russian authorities have tried anything possible to keep the nominal unemployment figures at record lows. Alongside the nominally strengthened (but practically useless) ruble rate and mild officially reported inflation rate, these are the key pillars of Putin's 'Potemkin' picture of the status of economic affairs, into which many of the Russia watchers are, unfortunately, easily duped. Currently reported unemployment is below 4%, which leads many to conclude that Russia is somehow coping with the effects of sanctions.

However, alongside the official low unemployment figures, there are shocking numbers of people who, since the beginning of the war, fell victim to various palliative forms of hidden unemployment - part-time work, downtime and unpaid leave. Russian authorities, considering unemployment a socially and politically sensitive issue, have developed a habit over various crises to put pressure on employers to force them to refrain from laying off their employees, instead opting for these forms of unemployment surrogates, and thus keeping public unemployment figures low.

The numbers are shocking. At the end of Q2 2022 (the last available figure), Rosstat reported that about 13% of the total Russian corporate workforce (workforce excluding those employed in the small business sector), or 4,3 million people, were subject to part-time work, downtime and unpaid leave (of which unpaid leave is the most widespread format, affecting 2,9 million people). The hardest hit sector was the manufacturing industry - which, as we have explained above, was severely affected by the sanctions. In total, around 1,3 million employees from manufacturing industries were subject to these forms of hidden unemployment - about one-third of all Russian workers affected by these measures. The share of hidden unemployment in manufacturing industries reached as high as 24.4% of the total workforce, according to Rosstat.

The are no miracles, and businesses will need to begin firing employees at some point. The Government admits that, but tries to contain these trends through informal pressure on employers for now. Unemployment will inevitably grow, and the current "hidden unemployment" is not very much different - given that most of the de-facto unemployed are on unpaid leave.

Consumer purchasing power decline for a straight decade

The Russian Government hasn't reported a major contraction of Russians' real incomes since the beginning of the war - only by 1.7% for 9 months of 2022, but that indicator is tricky. It underwent an array of methodological changes and revisions in the past few years, is non-transparent, and is based on official inflation figures, which are, most likely, underreported. A much more credible indicator is retail sales, which fell about 9% lower year-on-year since April, and are not rebounding - showing an L-shape curve. Putin admitted in early October that the decline in retail sales was a problem that the Russian authorities were not able to solve since the beginning of the war, and since the mobilisation was announced in September 2022, the situation has deteriorated further.

It should be noted that even before the war, real incomes of Russians were significantly lower than in 2013 before major sanctions were imposed on Russia as a result of the illegal annexation of Crimea and Donbas. Estimates vary - for instance, according to the estimates of the Russian Development Centre (which are probably too optimistic), by the fall of 2021, real incomes were about 7% lower than in Q1 2013; Forbes estimated the decline of real incomes in mid-2021 as compared to 2014 by 10%. Now, real incomes are clearly even lower; it is probably fair to say that Russians are, on average, 10-15% poorer than they were before Putin's invasion of Ukraine in 2014.

Almost a decade of decline in real incomes inevitably produces significant fatigue - which becomes an even larger problem on the back of a lack of viable prospects to improve this situation. For instance, the federal budget for 2023 (which is in the final stages of approval) envisages indexation of social benefits only by about 12%, which will most certainly keep real incomes in the negative territory for the 10th consecutive year.

Russians also lack savings to support them in times of trouble. According to NAFI, only 15% have savings that may allow them to maintain current spending levels in the event of a full loss of income; 67% don't have savings at all or only in the amount which may allow them to sustain themselves for no longer than three months. Due to this, people attempt to sustain themselves by borrowing more cash from banks - but this only leads to growth in consumer loans, which have already exceeded 10% in the total consumer loan portfolio of the Russian banks by the end of Summer, as the Russian Central Bank reports.

Decline in the quality of life

Various indicators and consumer surveys indicate a notable decline of quality of life in Russia. According to a survey by Roskachestvo and NAFI, about a third of Russians noted a decline in their quality of food. According to October Romir data 68% of 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%), cars (53%), non-food products and clothing and footwear (50% each).

Only slightly over 50% of Russians are satisfied with their quality of access to social media, mobile apps and audio streaming, and less than 50% with the quality of video streaming. The latter is the result of both the disruptions in the supply of technology and component parts for the communications industry, as well as the deliberate actions of Russian authorities to block access to Western social media outlets and apps for Russians. According to available data, the import of smartphones is significantly down, having been replaced by the growing imports of push-button phones. Russians will need to give up their habit of driving high-quality imported cars - and Russian substitutes significantly reduce the comfort of driving.

This situation is set to deteriorate further as the economic effects of sanctions will progress; Russians are gradually forced to return to the quality of life standards known 15-20 years ago at best.

Possible social and political implications of the economic crisis

Many Russia watchers often prefer to jump straight from point A to point B - whenever certain political and economic troubles in Russia are reported, impatient questions are asked about when these developments may lead to a significant political change, including the possible removal of Putin from power. We're not there yet. Putin's system still has a lot of strength remaining. His elites are weak, totally dependent on the resources and authority allocated by Putin, and largely incapable of challenging him. It is probably worth saying that elites in

Russia simply don't exist in a classical Western political analysis sense - one clear example of this is the broadcast of the Russian National Security Council meeting in February 2022 prior to the invasion of Ukraine, where the total domination of Putin over the supposedly key figures in the state was evident and unchallenged. The population is scared due to the highest level of mass political repression since probably the 1950s. Organised political opposition was destroyed even as early as 2021, with Alexey Navalny imprisoned, and most other prominent political leaders either detained or forced into exile (we can now be more or less certain that the crackdown on organised opposition in 2021 was happening as a pretext to the invasion of Ukraine, to prevent a major organised anti-war protest movement to emerge as it did in 2014).

In such an environment - elites destroyed, opposition destroyed, population disorganised and unprecedentedly scared - political change as a result of social and economic woes may take longer and be a little less predictable than classical patterns of political analysis may suggest. However, there are clear trends emerging in the recent few months; public discontent with Putin is mounting. When people are asked less direct and less political questions - are you satisfied with your life, do you have concerns, are you confident in the future, do you watch and/or trust the state media - the emerging picture clearly shows that the majority of Russians are heavily distressed, uncertain about the future and demand serious changes to the way country is governed - as per one very recent Levada Center poll.

However, there is nowhere else to go: recent Russian history, including the period of 2008-2022, suggests that public discontent with economic troubles will sooner or later translate into political activity. Repression and money can only hold off this process for some time - but at the moment, Putin's financial capacity has been severely undermined by sanctions, and he can't even allocate significant resources to finance his war, not to mention solve all the country's problems caused by sanctions. Mechanisms of the future disintegration of Putin's governance system remain unclear, but, based on the simple law of physics, Putin's system has taken on too much weight, which it simply can't handle.

One of the assumptions is that Putin will be able to sustain control over society for an indefinite period of time, like the regimes of Iran and North Korea. However, there are two arguments against that point:

1. Putin's regime was never as repressive as Iran or North Korea, much of Putin's popularity was based on "soft power" embodied in corruption and the bribing of society, as well as propaganda and censorship. The Iranian or North Korean style of mass repression will require an enormous repression apparatus which is simply not there; there are reasons to believe that the security apparatus will disintegrate if tasked with carrying out true mass repression.

2. The relevant comparisons for Russia are probably not Iran or North Korea, but apartheid-era South Africa: due to sanctions, Russian society will experience such a significant downshifting of living standards that Iran or North Korea have never experienced in the first place (they were always much poorer and more authoritarian countries than Russia, and haven't experienced rapid downshifting as Russians currently have in the past decades). Apartheid South Africa appears to be a more relevant comparison - and some of the academic works argue that, while the impact of sanctions on the South African economy were limited, it was the negative psychological impact of international isolation on the white South African population that helped to accelerate the change.

Rapid downshifting of Russian society can be politically dangerous. When it happened before in the 1980s and 1990s, it eventually led to changes in the regime: first, the collapse of the USSR, and second, the plunging of approval ratings of Yeltsin's government on the back of a rapid shift in support towards a "strongman rule" already by the end of 1999, on which Putin had capitalised himself, dismantling Yeltsin-era democracy.

These assumptions are supported by certain signs of Putin's cautiousness about public opinion - yes, he does care about it, which can be seen from a wide range of issues since the beginning of the war: from hesitation to announce mass mobilisation until September, to downplaying its scale in public and constant announcements that "mobilisation has ended", to hasitation to block a very popular YouTube platform, to the imprisonment of some prominent and popular figures with anti-war positions like Yevgeny Roizman or Yury Shevchuk.

At some point, public opinion will speak, and Putin will hear it. Sanctions will play a key role here: while they were not meant to be targeted against ordinary Russians, in the modern globalised world, nonetheless, Russians will be able to feel the full extent of the negative consequences of Russia's international isolation and the break away from the rules-based international order.

IV. Can Russia achieve more economic independence from the West?

Putin and his government are now desperately trying to minimise the negative effects of sanctions by focusing on alternative economic policy directions which they view as lifelines capable of minimising the damage done by sanctions. In summary, there are three major policy directions of that kind: import substitution, pivot to Asia, and grey schemes of trade and imports through third countries to circumvent the sanctions imposed on Russia. Let's briefly consider whether they are working.

Import Substitution

Russian authorities have long mulled import substitution as an answer to the problems caused by the rift with the West, and have more actively promoted this policy since 2014. Although this policy is working to some extent, there are fundamental obstacles to import substitution being truly successful. The Russian economy is significantly monopolised by a limited number of actors affiliated with the state. Low competition, domination of ineffective state-affiliated players, and high corruption destroy incentives for innovation and the development competitive products. For instance, it is widely regarded that the embargo imposed by Putin in 2014 on Western food imports has caused higher prices and deteriorating quality of food, with benefits largely reaped by a handful of large agricultural holdings close to the Russian state.

Another problem is that complex products require significant international cooperation to ensure cost competitiveness and satisfactory quality. However, that possibility is currently closed for Russia. Attempts to jointly develop certain advanced products in cooperation with Asian partners ended up in some spectacular failures: for instance, about a decade ago, Russia and China began developing the idea of manufacturing a joint CR929 widebody passenger aircraft. As of mid-2022, Russia has openly admitted that the cooperation on CR929 had gone nowhere, and it considers pulling out of the program. Russian Deputy Prime Minister Yury Borisov said that "we are working with China on this project which, in principle, is not going in the direction that suits us. China, as it becomes an industrial giant, is less and less interested in our services. Our participation is decreasing and decreasing. I don’t want to predict the future of this project if we are going to leave it or not, but for now, this is really the way”.

One of the most notable failures of Russian attempts to substitute complex imported products and technologies was the Yamal LNG project by Novatek, a gas production company. Novatek had developed its own unique gas liquefaction technology “Arctic Cascade” and wanted to build a 4th LNG train at Yamal LNG relying solely on that technology and the equipment produced by Russian factories. Ultimately, the equipment did not work properly. The situation was so bad that, in March 2021, Novatek was forced to terminate all contracts with Kazankompressormash and other Russian factories, and switch to cooperation with German Linde AG for further efforts. This story also shows that the Soviet manufacturing legacy is not particularly helpful to achieve competitiveness in the modern world, as former Soviet factories lack the client orientation tradition and experience needed to develop high-quality products adequate to modern market demands.

In past years, Russia also tried to develop its own CPUs, Baikal and Elbrus, as an alternative to Intel and AMD processors. Recent studies show that they simply can’t compete with current market leaders. At the end of 2021, Sberbank tested the Elbrus CPUs for applicability in their ecosystem, and found out that they meet only 16% of the requirements.

There are also structural factors at work: the Russian economy under Putin was intentionally monopolised, either through the creation of “United State corporations” to develop strategic sectors, or transferring certain areas under dominating control by some of Putin’s cronies. This monopolistic environment dependent on state budget financing is failing to stimulate efficiency, innovation and client orientation.

The whole experience of 2014-2022 shows that, while Russia can achieve certain levels of import substitution in more primitive sectors of the economy such as basic food, in the current environment - isolation from international cooperation, ineffective Soviet manufacturing legacy, and an economic system dominated by obsolete and corrupt state monopolies - import substitution efforts in more complex industries are largely doomed to fail.

Pivot to Asia

Rearranging Russia's trade and investment flows in favour of Asia instead of Europe had long been mulled by the Russian leadership as the way to achieve economic independence from the West. However, there are clear and objective limitations: many of these have been discussed in the paper "Ambitions Dashed: Why Sino-Russian Economic Cooperation Is Not Working" published by the author of this paper with the Martens Centre in 2021. The main economic activity in Russia is concentrated in the European part of the country, and trade with Asia is complicated geographically. For historical and market reasons, there is not much economic gravity between Russia and Asia. Russia does not produce competitive goods beyond raw materials to offer to the Asian market. Asian markets are saturated, and Russia can't get a favourable pricing environment there - whereas supply chains are more expensive due to large distances and a lack of infrastructure.

Take oil, for instance. Shipping Russian oil to Indian and Chinese ports from the main Russian oil export terminals in the Black and Baltic seas is a logistical nightmare. Not only does it take much longer (about a month of shipping oil to India versus a couple of days to Rotterdam or Genoa), tankers must go through a long list of bottlenecks - Danish straits, Gibraltar, Bosphorus, Suez Canal, Bab-el-Mandeb strait - where they run a risk of delays and demurrage imposed. On average, shipping oil to Asia, as opposed to Europe, generates an estimated extra cost of $10 per barrel or more.

At the same time, Asian consumers, facing a sudden oversupply of Russian oil, are imposing serious discounts - since the beginning of the war, Russian oil exporters were forced to sell oil to Asia at a $25-35/barrel discount. This situation will only get worse as the EU oil embargo comes into effect, and more Russian crude oil volumes arrive at the Asian market, adding to the supply excess.

When it comes to natural gas, the situation is even worse: the infrastructure connecting Western Siberia, the main Russian natural gas-producing region, with major Asian consumers like China or India is simply non-existent. Building it would require investments in the range of $100 billion or beyond - based on the experience of construction of the "Power of Siberia" pipeline connecting Eastern Siberian gas fields and Northeastern China (a much lighter undertaking). Major questions remain whether these large new volumes of Russian gas will be in demand or can the gas be supplied at a profit. The natural gas balances of China and India for the next few decades are studied more or less well. There may be some niches for extra Russian gas, but definitely not to the extent that could substitute the loss of the European gas market for Russia. As far as price is concerned, the experience of the "Power of Siberia" pipeline is discouraging. When the agreement to build the pipeline was signed in 2014, it was announced that the price of gas supplied to China would be in the range of $350-380 per thousand cubic meters (tcm), which was close to a near-zero profit price, as can be seen from Gazprom's requests to the Russian government to exempt this project from most of the taxes (Gazprom officially admitted that, without zeroing out the taxes, the project will not be profitable). However, since the pipeline's inauguration in 2019, Gazprom has been selling gas to China via the "Power of Siberia" at barely over $200 per tcm or lower. This means that even current gas supplies to China from nearby Eastern Siberia are not profitable, not to mention justifying the construction of new massive infrastructure from more distant Western Siberia.

Russia theoretically can build more LNG plants to help its gas reach the Asian market, but here some important technology bottlenecks are emerging which hold back key potential LNG projects such as Arctic LNG-2, Baltic LNG, Ob LNG - from unique heat exchangers manufactured by German Linde or U.S.-based Air Products to LNG carriers that were supposed to be built in South Korea, but now the Korean partners have pulled out of the project. Since the beginning of the war, China also began demanding significant discounts from Russian LNG suppliers.

It is extremely unlikely that Asian partners will be willing to help Russia create more competitive products to be supplied to Asian markets - they simply do not want competition from the Russian side. The aforementioned failing attempt to build a widebody passenger aircraft CR929 together with China is a clear illustration of that; in previous years, it became clear that the Chinese do not even want to grant Russians any rights for marketing the aircraft inside China once it is built.

The current structure of trade between Russia and the Asian countries suggests the limitations of economic cooperation: Russia is only suited to supply Asia with primitive raw materials, whereas importing more complex products for its own domestic needs on the background of the collapse of imports from the West. For instance, about 70% of the current Russian exports to China are oil, gas, coal, raw wood and pollock, whereas China supplies Russia mainly with electromechanical products, equipment and machinery, electronic products, vehicles, etc. Supplies of raw materials to China also result in low-profit: apart from the above-discussed discounts on oil & gas, other Russian commodity exporters face the stark choice of offering Chinese deep discounts to find a niche in their market. For instance, the director of major Russian coal-producing company SUEK, Maxim Basov, has admitted that “With sanctions, only those markets remain open for us which need cheaper coal. Markets where we can be discounted by 50% or more compared to similar products from Australia”. And this happens on the ground of high transportation costs - according to Basov’s estimates, logistics weigh as much as 50-75% in the price of the delivery of coal to Asia.

Circumventing sanctions

Unfortunately, this is the area where Putin had been relatively successful, and there are certain countries that are willing to cooperate and assist him in doing so. One of the obvious choices was China, which had increased its imports to Russia during nine months of 2022 by over 10%, or by about $500 million per month. However, this is little in comparison to the potential scale and expectations about increasing Sino-Russian cooperation as promoted by Putin and his propaganda along with some experts. What is truly striking is the extent to which Turkey - the other key Putin ally in circumventing sanctions - seems to be willing to contribute to keeping Putin’s regime afloat. Currently, Turkish exports to Russia stand at the level of about $1 billion per month, up more than two times year-on-year, and providing Russia with similar levels of substitution of lost Western imports as China. Some of the other G20 countries which have so far abstained from imposing sanctions on Russia - like India and Brazil - have reduced their exports to Russia in 2022, actually refraining from filling the niche left by plunging Western exports of investment and consumer goods, but China and Turkey have both contributed positively to Russia’s attempts to find alternative sources of imports.

Since Turkey is a NATO member country and a nation deeply integrated with the Western world, it becomes a key policy issue of the current moment to ensure that Turkey joins sanctions against Russia, and reverses its current policy of de-facto assisting Putin with circumventing sanctions. This is even more important given the fact that most Russian trading routes go through the Black Sea, with Turkey potentially playing the key role in interrupting them.

There are also credible indications that Israel is actively helping Russia to circumvent sanctions.

As mentioned before, parallel imports have not been effective for a number of reasons. There are no large stocks of goods available for parallel imports; it is legally risky; costs are higher and many other problems persist. So far, parallel imports fell short of expectations regarding helping Russia to circumvent sanctions - much more effective is working with countries which are willing to assist in replacing lost export and import opportunities, primarily China, Turkey, Israel and Central Asian countries.

V. Conclusions

While the impact of international sanctions introduced against Russia since Putin's 2022 invasion of Ukraine is still in its early stages, it is clear that sanctions are producing a severe negative effect on the integrity of Putin's economic model, and have a wide effect across large numbers of key sectors of the Russian economy. The effect of sanctions is likely to significantly increase over time, as Russia struggles to find new markets, technologies, capital, suppliers of component parts, and in many areas, satisfactory substitutes won't be found, pushing Putin's economy backwards.

Given the effects described above, it is profoundly wrong to state that sanctions against Russia are "not working" or "have little effect". On the contrary - their effects across various sectors of the Russian economy are tremendous, and progressing over time, being reinforced both by new expected measures (like the upcoming EU oil embargo) and Putin's own actions which have multiplied economic challenges (such as mobilisation). There are only limited reasons why sanctions haven't currently produced a catastrophic effect:

- A temporary surge in oil prices in the first months of the war, allowing Russia to accumulate some extra financial surplus;
- Accumulated financial reserves which afford some manoeuvre;
- Classifying vital statistics, which would show the real disastrous picture if published;

• Deliberate regulatory interference (like cancellation of free convertibility of the ruble and pressure on employers to prevent layoffs of workers), which can only provide an illusion of stability for a short period, without solving the fundamental underlying problems;

• Manipulatory psychological disinformation campaign by Russian authorities (to which, unfortunately, many in the West have fallen victims) aimed at using a handful of misleading macro indicators (on the background of hidden detailed statistics) to create a false impression that “Russia is weathering the sanctions”.

This paper has a specific purpose to show a much broader picture of the impact of Western sanctions on the Russian economy, using many detailed indicators which are available, but largely out of the public eye, overshadowed by a narrow set of macro parameters. A closer look at these suggests a more complex, systemic impact of sanctions.

Sanctions are producing significant effects both on the supply and the demand side of the Russian economy, causing a significant downshifting of the Russian economic system to an extent unseen since the 1980s and 1990s - when such downshifting had indeed produced political changes.

The alternatives available to the Russian government - import substitution, a pivot to Asia, sanctions evasion and “grey schemes” - will produce only limited effects due to fundamental constraints. The Russian economic situation will continue to deteriorate in spite of multiple voices claiming that Russia is “weathering the sanctions”. Western policymakers should exercise strategic patience when it comes to the effects of sanctions against Putin’s regime, develop a detailed methodology for assessing the effects of sanctions and refrain from listening to the advice of those arguing that “sanctions are not working” based only on a handful of irrelevant surface indicators - such an approach is fundamentally flawed.

Key policy recommendations with regard to sanctions policy against Putin’s regime:

1. Exercise strategic patience when it comes to sanctions policy. Study the deep long-term impacts of sanctions on the Russian economy. Don’t look at the watch every 5 minutes asking yourself whether sanctions are working or not if Putin still hasn’t stopped the war. Sanctions alone cannot change Putin’s policies because his regime still has some strength and reserves left, but they are a very important component of multi-level

pressure on Putin's system, which eventually will not have the capacity to withstand all the pressures.

2. Don't judge the status of the Russian economy by a handful of misleading macro indicators. Treat Putin's policy of an artificially maintained narrow set of economic parameters (ruble exchange rate, unemployment, etc.) as a disinformation operation.

3. Make sure that the EU oil embargo on Russia comes into full effect as planned without backtracking.

4. Discuss more future sanctions (there are many options still available, which are the subject of further analysis), but always consider the systemic effect together with the measures that have already been adopted. The current sanctions are quite effective in their own right, and future sanctions should be considered as an instrument of enhancing the sanctions policy and strengthening the effects that have already been achieved.

5. Work with third countries to ensure that they, at a minimum, stop helping Putin to carry out successful sanctions circumvention policy. This is Putin's key lifeline at the moment. Turkey and Israel in this regard are key countries to focus on.

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