From Bad to Worse:

The Continuing Effects of Sanctions on Russia

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Wilfried
Martens Centre
for European Studies

June 2023

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This publication receives funding from the European Parliament.

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This paper is a follow-up to the comprehensive report "Beyond the Headlines: The Real Impact of Western Sanctions on Russia", which was published by the Wilfried Martens Centre for European Studies in November 2022. Back then, the paper argued that the widespread view of Russia "weathering" the sanctions, which supposedly brought only a "limited" impact, was wrong, and actually based on an erroneous focus on just a handful of manipulated or misleading macroeconomic indicators, such as GDP, the ruble exchange rate, unemployment, and inflation. A broader cross-sectoral look and focus on a wider set of indicators more realistically reflecting the contraction of economic activity showed a totally different picture: that the sanctions in fact were having a much wider, systemic, and lasting economic impact, which would only continue to increase over time. This meant that sanctions were working, and strategic patience was needed to see their full, devastating impact on the Russian economy. And all this was before the EU embargo on Russian oil came into effect, cutting Russia off yet another significant part of its energy export revenues.

Since then, the situation has gotten much worse for Putin and the Russian economy. First and foremost, the EU oil embargo - on the backdrop of intensified Russian military spending - has thrown Russia into a full-blown budget crisis, something which the country was able to escape in 2022. The 2022 fiscal year ended with a significant deficit (2,3% of GDP) after being in surplus for 11 months; in the first four months of 2023, the budget deficit has exceeded the planned annual deficit (envisaged by the federal budget law) by 17%. It is important to note that, with a significant drop in private and foreign investment, the economy has increased its reliance on state assistance - the weakness of governmental finances, therefore, is a major impediment to any recovery.

Overview of the current situation

In January-April 2023, the Russian economy showed some signs of recovery against the weaker months of late 2022[1]. Industrial output saw a 0,6% year-on-year increase in the first four months of 2023, but is largely driven by war-related industries, while other industrial segments are in depression. Retail trade turnover has switched from annualised contraction to growth (7,4% in April), but only in comparison to disastrous numbers of April 2022, and is still well below the pre-war levels. Cargo turnover improved to -2,1% in January-March versus -4,6% in December; annualised inflation is shrinking, falling to as low as 2,3% year-on-year in April 2023.

Moreover, in the next few months we will see significant improvements in the annualised indicators of the Russian economy because of the low base effect: they will be compared to April-May 2022, the most dramatic post-war months, when the effects of sanctions were first being felt by the Russian

[1] Source of statistics in this report: Russian Federal State Statistics Service. Report "Socio-economic situation in Russia", May 31, 2023. https://rosstat.gov.ru/compendium/document/50801. Accessed June 1 2023.

economy. Undoubtedly, we'll hear much fanfare from Russian propaganda outlets and their purposeful or unwitting echoes in the West about these "improvements".

However, these numbers should not mislead anyone. The actual picture is closer to stagnation than it is to recovery - as can be clearly seen from the seasonally adjusted graphs provided by Rosstat, the official Russian statistics agency. Industrial output and retail trade are still below the pre-war levels; industrial recovery is highly uneven, being driven largely by the military-related production. Cargo turnover is picking up largely because of massive shipments of coal and petroleum towards the East, i.e., China and other Asian markets, which are low-profit exports that hardly generate any significant added value for the economy; in many other areas of economic activity, cargo turnover remains depressed.

Rosstat has recently published the full breakdown of Russian GDP for 2022 - which had contracted by a mild 2,1%, leading to much celebration by Putin and his allies of how resilient the Russian economy turned out to be against sanctions. But that figure includes 3% GDP growth in the first quarter of 2022, when Russia was mostly unaffected by sanctions; for most of the remaining months, GDP contraction was 4-5%.

Even more interesting is the breakdown by sectors – which shows a clear picture of GDP-positive contributions dominated by the wartime economy, with normal economic activity being in depression. The other factor distorting the picture is the record grain harvest of 2022 - which had itself led to major negative consequences like overstocking of grain, and a possible drop in future agricultural production.

Notably, in many vital civil sectors of the economy (extractive and manufacturing industries, trade), the situation in the fourth quarter of 2022 had worsened as compared to overall annual results - whereas in military-related sectors, output increased. This gap between military-related and the civilian economy has widened over time and will continue to do so.

Table 1. Sectoral input into Russia's 2022 GDP growth: gross value-added growth index by sectors (source: Rosstat)

	2022 total (% to 2021)	4th quarter of 2022 (% to Q4 2021)	Share of total GDP in 2022, %
Agriculture	106,7 %	106,4 %	4,3 %
Construction	105 %	106,1 %	5,2 %
Public administration and military security	104,1 %	107,6 %	7,1 %
Administrative activity and related services	102,4 %	103,5 %	2,2 %
Information and telecommunications	100,5 %	100,4 %	2,7 %
Extractive industries	100,4 %	97,1 %	14 %
Manufacturing industries	97,5 %	95,2 %	14,2 %
Retail trade	87,3 %	82,7 %	12,4 %

As can be seen, in the major sectors which comprise 40% of Russian GDP - industry and trade - the situation looks quite depressing and is not improving, whereas the overall “mild contraction” picture is helped by the limited number of military-related industries, plus the good result of the first quarter of 2022, and the record grain harvest of 2022.

So even though, in nominal terms, annualised figures in the coming months will normalise and will look more like a “recovery” - about which Putin will spare no chance to boast - in reality, the picture is really one of stagnation. There are key factors impeding further recovery: a depressed investment climate in key sectors, massive capital flight, low consumer demand, and a worsening deficit of a skilled workforce (an obvious side effect of the war). According to the most recent Rosstat survey of business confidence, low domestic demand and a skilled workforce deficit continue to dominate among key entrepreneurs’ concerns impeding development.

On the background of stagnation in the major sectors of the economy, the beginning of 2023 was marked by a rapid development of the crisis of governmental finances – something that Russia was able to avoid in 2022. It is the most important headache for Putin’s government today, because in the current wartime and state-dominated economic model, the state’s ability to allocate financing for military, economic and social needs remains the only vital stabiliser of the economic situation - and money is swiftly running scarce for the Russian government.

Crisis of Government finances: key metrics to monitor

The beginning of 2023 was marked by two major trends in the government’s finances. First, oil & gas revenues dropped sharply, mainly due to the EU’s oil embargo. According to the Russian Ministry of Finance, oil & gas revenues of the federal budget dropped by a startling 52,3% year-on-year in the first four months of 2023. Also, Putin’s voluntary cutoff of natural gas supplies to Europe, and the total loss of the European market for an indefinite period, played a role here.

Indeed, Russia managed to significantly increase Liquefied Natural Gas (LNG) supplies to Europe in 2022 and beyond, but LNG, unlike pipeline gas, goes almost untaxed in Russia - LNG projects like Yamal LNG were built with massive tax exemptions granted - which means that LNG exports do not generate any significant revenue for the state budget. The same thing goes for natural gas exports to China: although they have significantly increased in 2022, they go almost totally untaxed, so, for the Russian budget, it doesn’t make a difference.

Second, the Russian government had financed an unprecedented amount of military expenses up front (which is not normally the case; usually, all government agencies, including the Ministry of Defence, receive most of the allocated budget funds closer to the end of the year, or at least evenly throughout the calendar year). According to estimates based on data from the Ministry of Finance, over 3 trillion rubles were transferred to the Ministry of Defence in January-April 2023 - or over half of the total annual budget for 2023 (which is 5 trillion in total, including all secret articles).

Given the information from the front - about the chronic shortages of supplies, ammunition, etc., and even considering the limited combat intensity of the past months, with Ukraine tempering the launch of its expected major counteroffensive - it is highly likely that the Russian Ministry of Defence will soon run out of its allocated annual RUR 5 trillion budget, and will ask for more money, which will only worsen the current budget crisis.

Make no mistake here: sanctions are already seriously impeding Russia's ability to wage war against Ukraine. It is probably fair to say that the failure of Russia's winter offensive against Bakhmut and other directions in Donbas can be partially attributed to a lack of funds, including the "artillery shell hunger", which was highly publicised by the Wagner mercenary group and other Russian sources.

The non-oil & gas revenue of the federal budget turned positive after four months of 2023 (+4,8% year-on-year), but the corporate profit tax collection is in deep in negative territory (-19,4%), indicating growing costs of business activity on the background of depressed economy.

On the background of all this, the Russian Ministry of Finance has reported that the total budget deficit in January-April 2023 has reached 3,4 trillion rubles, or 17% above the planned deficit approved for the whole year as part of the federal budget law (2,9 trillion rubles)[2]. Oil export revenues have plunged sharply: in January-May 2023, the average price of Urals oil was reported as $51,5 per barrel, increasing somewhat in April to $58,6 due to market influence of oil output cuts announced by OPEC, but then falling again in May to $53,3 per barrel[3].

The Russian official budget for 2023 was approved, basing itself on the Urals oil price forecast of $70 per barrel on average for 2023; since the EU oil embargo came into effect in December 2022, the actual price has been just over $50 so far. It is important to stress that the difference between $50 and $70 per barrel is essentially vital for the Russian state budget - the Russian oil taxation system is progressive in relation to the export oil price, so with prices at $50 per barrel or below, the oil producing industry still obtains good revenue that well covers their costs of producing and shipping the oil (which is why the oil output in Russia hasn't significantly contracted), but it is instead the budget which suffers most of the revenue losses, after prices dropped to below $50 from the forecasted $70 per barrel.

How much money is still left for the government? The National Wealth Fund - Russia's sovereign rainy day fund - held RUR 12,5 trillion as of May 1st, 2023, according to the Russian Ministry of Finance. However, only 54% of that sum - RUR 6,8 trillion - are "liquidity funds", or actual cash at the Finance Ministry's accounts in the Central Bank[4].

[2] Ministry of Finance of Russia. "Preliminary assessment of the execution of the federal budget for January-April 2023", May 10, 2023. https://minfin.gov.ru/ru/press-center/?id_4=38473-predvaritelnaya_otsenka_ispolneniya_federalnogo_byudzheta_za_yanvar-aprel_2023_goda. Accessed June 1 2023.

[3] Ministry of Finance of Russia. "On average Urals oil price", June 1, 2023. https://minfin.gov.ru/ru/press-center/?id_4=38508-o_srednei_tsene_na_neft_marki_urals. Accessed June 1 2023.

[4] Ministry of Finance of Russia. "On the results of the allocation of funds from the National Wealth Fund", May 05, 2023. https://minfin.gov.ru/ru/press-center/?id_4=38472-o_rezultatakh_razmeshcheniya_sredstv_fonda_natsionalnogo_blagosostoyaniya. Accessed June 1 2023.

The rest is invested into various shares, bonds and projects of state-affiliated banks and corporations. These are still assets, but they are not liquid - it would take time to convert them into cash. Essentially, "cash on hand", which can be used to cover the deficit - 6,8 trillion rubles – is equal to the combined deficit recorded from 2022 (RUR 3,3 trillion) and the first four months of 2023 (RUR 3,4 trillion). The Russian Finance Ministry managed to keep the National Wealth Fund largely intact since December - through borrowing and using carry-over cash balances to finance current expenses - but it will have to begin drawing money from the National Wealth Fund soon.

With the current growing deficit, it is inevitable that, at some point in 2023, the National Wealth Fund will be fully spent. There are not many other options for the government to fill the void. One option would be to try to mobilise cash reserves held by the population – for quite some time, the Russian government has been mulling over the idea of issuing "popular bonds" to get the state's hands on the people's money. But so far, there has been limited demand from the population for investing in government bonds.

The other option is raising taxes. The Government has already moved in that direction. First, it had introduced a "voluntary one-time windfall tax" (estimated as RUR 0,3 trillion in revenues) on fertilisers and other industries that are believed to have received "excessive superprofits" in 2022. Second, the rules of imposing taxes on the oil industry have been adjusted, so the taxes on oil exports will no longer be imposed according to the actual market price of oil, but rather according to a higher price which the government believes to be "fair" (this is supposed to "stimulate" oil companies to negotiate a reduction of discounts for Russian oil with buyers in Asia and elsewhere).

Needless to say, raising taxes is the last thing the economy needs in the current depressed economic climate, and the effects of this decision will most likely be negative for any potential recovery.

After all, at some point in the near future, when the National Wealth Fund will be spent, and there will remain little room for further tax increases, the government will turn to monetary emission as a means to finance the budget deficit - which will inevitably spark inflation. To be honest, the current financing of the deficit with National Wealth Fund money, on the background of depressed economic and entrepreneurial activity, is hardly any different than printing money - which is why the Russian Central Bank openly recognises deficit financing through NWF as one of the pro-inflationary factors, and refuses to further lower the interest rate because of that from the current level of 7,5%, which is clearly prohibitive for economic recovery.

But it is not only inflation that matters; most importantly, as said above, direct involvement of government finances is currently the only lifeline for the economy to sustain itself, as Russia can no longer count on private investment. Investment in the key privately owned sectors like manufacturing industries and trade is depressed (see below). Foreign investment is just not arriving: capital flight in 2022 has hit an absolute historic record of $227 billion dollars, and the mass corporate exodus from Russia is just beginning - which means that capital flight will not end any time soon. Remarkably, no major new investments are coming from Asia: after the 2022 invasion and the sanctions introduced by the West, Russian authorities have been promising that Western corporations will be replaced by Chinese, Indian and other companies from the non-Western world, but this has so far failed to materialise, and will most likely not happen at all. Apart from the general toxicity of investing in Russia, the Russian government since the beginning of the war has been introducing a lot of wartime regulatory measures - from draconian capital controls to the requirement that foreign investors should obtain mandatory permits to sell their assets - which has significantly elevated the risk of investment in Russian assets.

The prospect of running out of cash for the Russian government looks quite catastrophic: there are no other sources of financing for economic development. All this was precisely worded by one of Putin's sanctioned oligarchs, Oleg Deripaska, at the Krasnoyarsk Economic Forum in March 2023 - Deripaska had made multiple headlines by saying that "the government will run out of money by next year" and that "there won't be sufficient funds for the government to finance everything - we still need private investment".

One of the notable issues is that the Russian government was forced to cut the spending on economic aid in 2023 - it was cut by 17% in the federal budget approved for 2023 as compared to 2022. Social benefits were indexed only by about 12%, according to the "official" inflation estimate, which is significantly below the accumulated inflation, and will contribute to the continued shrinking of consumers' purchasing power.

Further fiscal constraints will severely undermine the government's ability to finance everything - the military, the bureaucratic and law enforcement apparatus, the economy, social programmes, etc.

The oil embargo is working

The EU oil embargo has played a critical role in the Russian budget crisis. Russian Urals oil prices have plunged below $50 in the first months of 2023 and are just slightly above that level now, according to the Russian Finance Ministry data - and so did the revenues from oil exports. As said above, oil and gas revenue of the federal budget plunged by 52,3% year-on-year in January-April 2023.

Russia was largely able to redirect the oil flows towards Asian markets - but, just as expected, purchases of Russian oil by buyers in saturated Asian markets came at huge discounts. The Russian government and exporters have tried various measures aimed at reducing these discounts - for instance, in the past weeks, the State Duma adopted the government-introduced law imposing a non-market method of calculation of oil export prices subject to taxation (basically, the government will dictate higher prices for the purpose of taxation than the actual Urals market price - to "stimulate" companies to negotiate smaller discounts on Russian crude with buyers). But discounts will persist, because Russian suppliers have less room for manoeuvre in terms of directing oil exports, since the European oil market was closed to Russian oil.

There has been much speculation about Russia's use of a "shadow tanker fleet", various schemes of blending and rebranding of Russia's oil, and Asian and Middle Eastern refiners and traders who help to resell Russian oil or petroleum products to the European market. Such schemes exist, and should be tracked and shut down, but generally, they don't appear to be having a significant mitigating effect for Russia against the oil embargo. First, for the state budget, these schemes don't matter, as oil is taxed at the Russian export terminals - so the shadow profits are left elsewhere. Second, the shadow profits are too dispersed among multiple players, who also pull their share of income, so that it would be a near-impossible effort to concentrate them for the benefit of Russia's financial system. So, while this issue of shadow trade in Russian oil is important, it is suggested that it is omitted from the general analysis of macroeconomic consequences of the oil embargo for Russia, because it doesn't play a significant role here.

As to the oil price cap imposed on Russia by the G7 countries, it is difficult to easily assess its effectiveness. First, the discounted Urals oil crude price was below $60 per barrel, even before the imposition of the oil price cap, so it is not easy to measure whether it was the cap that influenced the Russian oil sales price, or if it was simply the excessive offer of the Russian crude to Asian consumers which accelerated the discounts. Second, according to some data - including that of Chinese customs - some countries are buying Russian crude significantly above the price cap, within the range of $70-80 per barrel.

The issue here is that China gets a lot of premium Russian grades like Espo or Sokol, which are exported via the Eastern Siberia-Pacific Ocean oil pipeline and from Sakhalin, and are not as heavy sour crudes as Urals, being traded at a premium. The bulk of Russian exports - about two thirds - is still Urals, which is exported via Baltic and Black sea ports, which is why it is the discount for Urals that matters significantly in terms of Russia's budget oil revenue; lighter grades like Espo and Sokol make up only between 20-25% of the Russian crude oil exports, and that share can't be easily increased, because there is no more spare pipeline and railroad export capacity in the Pacific direction.

However, sales of Russian crude oil well above the G7 $60 price cap prove that the cap itself is not being fully enforced. It is the oil embargo that is quite effective in bringing down the price of Russian crude, by redirecting it to saturated Asian markets.

Private investment is dead

One of the key obstacles for Russia's economic recovery is the lack of sources for capital investment. The Russian government reported quite a positive growth figure in fixed capital investment as a result of 2022 - 4,6%. One might look at such a figure and think the Russian economy must be doing really well and "weathering the sanctions", if investments have grown that much; many Western observers certainly are.

But in reality, the 4,6% fixed investment growth figure is a distortion. Investment was reported to grow by 13,8% year-on-year in the first quarter of 2022 - before sanctions even began to work - and later fell to 2-3% growth in the remaining three quarters of 2022, and to just 0,7% year-on-year in the first quarter of 2023. Moreover - same as with GDP - if one does a breakdown between the war-related industries and the remaining civilian economy, it's clear as day that in areas related to the war and related state-funded efforts (transport, construction, public administration and military security, warehousing), investment is growing often by dozens of percentage points, whereas in key areas of the real-sector private economy, investment is down significantly.

Table 2. Dynamics of fixed investment in Russia by sectors in the first quarter of 2023 (source: Rosstat)

	Q1 2023 to Q1 2022
Public administration and military security	+92,8 %
Pipeline transport	+79,4 %
Railroad transport	+57,9 %
Construction	+0,3 %
Extractive industries	-8,8 %
Agriculture	-8,8 %
Pharmaceuticals	-11,8 %
Food industry	-15,0 %
Telecommunications	-16,2 %
Retail trade	-24,8 %

As can be seen, in major areas forming the real-sector private economy (manufacturing industries, trade, agriculture, telecommunications), which altogether comprise over a third of the Russian GDP, investments are declining significantly. Also, large boost in investments in the extractive industries (primarily oil & gas) did not translate into growth in output and budget revenues, and may have, to a significant extent, become stranded investments, due to the EU oil embargo and Gazprom's decoupling from the European gas market.

The sectors where investment boomed in 2022 are significantly state-funded, which means that the fiscal scarcity explained above will be a major impediment for such a wild ride to continue. On top of that, as said above, Russia had a record capital flight in 2022 ($227 billion), which is likely to continue as Western corporate exits from Russia are only in their early stages, and Chinese, Indian and other Asian investors are simply not coming. Russian Central Bank projects continued capital flight measured in tens of billions of dollars for 2023-2025.

Weak consumer demand: a key obstacle to recovery

Another major issue impeding Russia's potential recovery is weak consumer demand. Starting from April 2022, domestic retail sales shrunk by about 10% year on year, and remained at that level for the rest of the year. This figure has slightly improved in the first four months of 2023, but retail trade still remains at the level about 10% lower than in February 2022. It's quite clear that Russian economic troubles have caused a notable depression of consumer purchasing power, which is not truly rebounding to pre-war levels. According to Rosstat's entrepreneurial optimism surveys, more than a third of surveyed businessmen indicated "weak domestic consumer demand" as a key problem impeding the growth of output - second only to "overall economic uncertainty".

Industries in trouble

Although the industrial output in Russia may seem to be stabilising (a modest 0,6% year-on-year growth in January-April 2023), there are still major fundamental problems emerging due to Western sanctions, which will persist.

Extractive industries suffer significantly from the EU oil and coal embargoes and Gazprom's decoupling from the European gas market. Hard coal production was down by 3,6% year-on-year in 2022, and by 3,8% during the first three months of 2023. Natural gas production fell by 14,4% and 14,5%, respectively. Although coal and natural gas industries managed to contain further output decline, this was achieved by a re-orientation to domestic and Asian markets, which came with significant price discounts and negligible tax revenues (more on the prices of gas supply to China below). There are no further ways for Russian coal and natural gas to find new markets with comparable profitability compared to the lost European market.

Oil production largely stayed intact, with only a modest decrease by 0,6% year-on-year in January-February 2023 (after seeing growth of 2,1% in 2022). Since March 2023, Russian statistics agency Rosstat has stopped publication of the oil production data - visibly to avoid blame from OPEC over Russia's non-compliance with agreed oil production cuts. It is worth noting that the Russian oil producing industry is quite resilient to oil price drops to $50 per barrel or even lower, because of the progressive oil exports taxation - the party which suffers the most from such a price decline is the federal budget, not the companies. The oil producing companies have relatively low lifting costs, and are quite comfortable (and much less taxed) under the oil prices in the $40-50 range - which is why the oil output contraction as a result of the EU oil embargo was not so high (only the contraction of the budget revenues from oil exports were significant).

However, two factors may create additional difficulties for the oil industry. First, the costs of shipping oil to Asian markets is significant - additional costs of supplying oil from Baltic or Black seaports to India are in excess of $10 per barrel, which significantly minimises profits from oil exports. Second, the government has moved towards amending the legislation, with the purpose of increasing oil export taxation in the first months of 2023 - meaning that the tax burden on the oil industry would inevitably increase.

In the manufacturing industries, the picture is mixed in accordance with the dynamics explained previously, splitting into wartime-related and "normal" civilian sectors. As can be seen from the table below, the integral "stabilised" picture of the output is helped by the sectors which are clearly related to wartime production. The "champion" of industrial output growth in 2022-2023 were uniforms – no explanation needed. Some other surging production items include:

- "Finished metal products other than machinery and equipment"- the production of weapons and ammunition;
- "Computers, electronic and optical products" - radar devices, radio electronics;
- "Other transport facilities and equipment" - military aircraft, tanks, and armoured vehicles.

On the other hand, other key sectors are suffering from sanctions and lost access to international markets, Western technologies and component parts. The steelmaking industry's output is down significantly, as is the pharmaceutical industry, the carmaking industry, transport machine-building, engine building, etc. These are also very job-intensive industries - as explained below in the labour market section of this report, the various forms of hidden unemployment (unpaid leave, downtime, part-time working week) thrive in these particular industries.

Table 3. Output in selected Russian manufacturing industries, % to same period of the previous year (source: Rosstat)

	2022, total	Dec 2022	Jan-Apr 2023
Uniforms*	163,2 %	300 %	188,0 %
Computers, electronic and optical products*	159,6 %	199,6 %	118,7 %
Semiconductor devices and parts thereof*	109 %	123,3 %	100,4 %
Finished metal products other than machinery and equipment*	107 %	101,1 %	125,3 %
Other transport facilities and equipment	95,8 %	87,1 %	114,6 %
Rolled steel	91,9 %	84,1 %	98,7 %
Medicines and materials used for medical purposes	108,6 %	69,3 %	87,6 %
Freight cars	79,6 %	75,5 %	92,1 %
Rubber tires	78,6 %	57,5 %	66,6 %
Bodies for motor vehicles	79,4 %	70,4 %	77,5 %
AC motors	70,4 %	70,1 %	56,8 %
Internal combustion engines	66,9 %	39,8 %	55,7 %
Passenger cars	33 %	32 %	42,8 %

* Estimated to be related to wartime production

Agriculture: don't be fooled by the record grain harvest

The relatively successful results of the Russian agricultural sector in 2022 had distorted a lot of overall economic indicators - however, it is in reality just another Potemkin indicator. The impressive growth in agricultural output (10,2% year-on-year) was largely driven by a record grain harvest, which had backfired in many ways, and led to significant overstocking of grain, depressed prices, and decisions by many grain harvesters to limit production in 2023. In other areas, things were not going too well. Whereas the grain harvest grew by 26,7% year-on-year in 2022, the potato harvest only grew by 4,3%, sugar beet - by 1,2%, and harvesting of vegetables and sunflower seed had contracted by 0,1% and 7,5% respectively.

Despite much fanfare about "import substitution", the results of animal husbandry were modest to say the very least: the production of meat was up only by 2,9% year-on-year in 2022, milk by 2%, eggs by 2,7% (similar figures in these sectors were recorded in January-February 2023). Animal husbandry depends on Western technologies and a decent investment climate much more than grain harvesting - so the future doesn't look too bright here.

One of the key problems cited by agricultural producers are the difficulties with substituting Western agricultural machinery with Russian, Chinese and Belarus analogues (the alternatives are far less reliable and require constant expensive maintenance) and an enormous growth in logistics of delivery of anything needed for production, due to a re-orientation of logistical supply chains to Asia. Because agriculture is a low-margin industry, any significant growth in costs is often a matter of life and death to most producers.

Inflation picking up again

Despite Russian authorities permanently boasting about annualised inflation coming down to below 3% in April 2023 and onwards, in fact, this is yet another Potemkin village: these figures only appear in comparison to the high base of 2022, when inflation peaked in March-April. Even the Russian Central Bank recognises this: "Annual inflation will very likely drop even below 4% in Spring from today's 11.8% - however, this will not reflect current inflation trends", says Elvira Nabiullina, Governor of the Bank of Russia[5].

As of end-May 2023, prices in Russia, according to official estimates, have grown by 2,3% since the beginning of the year, and the Central Bank expects inflation to pick up in subsequent months. There are currently many pro-inflationary factors raising caution, as per Elvira Nabiullina: the deficit fiscal spending, the growing costs of logistics due to the re-orientation of supply chains to Asia, the shortages of skilled labour (see below for specifics on). After a short-lived period of insignificant deflation in the middle of 2022, prices are rising again: as of early April, the cumulative consumer price growth versus December 2021 has exceeded 15%.

Continuing inflation is a significant obstacle for rebuilding consumer purchasing power and for economic recovery, and there has been significant wrangling at the moment between the Russian Central Bank and the executive branch of government - which demands continued lowering of interest rates to stimulate economic recovery, but the Central Bank has resisted this due to high inflationary risks.

[5] Central Bank of Russia. "Statement by Governor of the Bank of Russia Elvira Nabiullina following the meeting of the Board of Directors of the Bank of Russia on February 10, 2023", February 10, 2023. https://www.cbr.ru/press/event/?id=14538. Accessed June 1 2023.

A Labour market in crisis

The situation in the Russian labour market is paradoxical. On the one hand, the government boasts about a record low unemployment - just 3,3% of the workforce, or 2,5 million people. On the other hand, quarterly Rosstat data on part-time employment suggests that, at the end of the first quarter of 2023, another 4 million employees were subject to various forms of hidden unemployment - mostly unpaid leave (70% of the total hidden unemployment), and also downtime and the part-time working week. It is very difficult to determine the actual difference between unpaid leave or downtime and being unemployed - which means that all that government's statistical trickery should be simply ignored. Russian labour laws make it difficult to lay people off, and the government usually puts pressure on employers in crisis after crisis to maintain a favourable unemployment picture. On the background of this, unemployment benefits are low, which means there's no motivation for employees to leave their jobs, instead of nominally keeping them without receiving pay.

If hidden and official unemployment are added up, total unemployment reaches up to 9% of the workforce. Russia has only ever had this high level of unemployment in the second half of the 1990s and very early 2000s. In manufacturing industries, the level of hidden unemployment is the highest - over 20% of the total workforce. Clearly, the complex industries most affected by sanctions feature the highest levels of hidden unemployment.

But, somewhat paradoxically, a totally opposite problem comes to light – the shortage of skilled labour. In the recent business confidence entrepreneurial survey by Rosstat, "shortage of skilled labour" was listed among the top 3-4 problems impeding output growth - after "overall economic uncertainty" and "weak consumer demand", and alongside "high taxation".

When Vladimir Putin was attending in-person the gathering of the Russian Industrialists and Entrepreneurs (RSPP) on March 16, 2023, shortage of skilled labour was most frequently mentioned by participants as the most serious challenge for business at the moment; members of RSPP have said that it was ranked number one among most serious problems for business in the survey of RSPP members - 70-75% of participants of the congress attended by Putin prioritised this problem as key. Elvira Nabiullina often mentions this problem as both one of the major pro-inflationary factors, and a key obstacle for economic growth.

Putin's war against Ukraine has clearly been a major contributor to the shortage of skilled labour exploding. On the one hand, many skilled personnel have been drafted for the war; on the other, hundreds of thousands of skilled workers have left the country to escape the draft. It is important to note that people who can materially afford to leave Russia and stay abroad for a prolonged period of time clearly work in advanced sectors and mostly represent the very same skilled workforce in question.

How does this deficit of skilled workforce match with large hidden unemployment? The problem is that hidden unemployment occurs in very specific areas, which require serious personnel retraining to fit labour market needs - e.g., the biggest hidden unemployment exists in manufacturing industries, and an industrial machine operator or adjuster can't immediately qualify for a job requiring IT or financial skills. Serious personnel retraining programmes are needed, which may take years - and the government is failing to address this problem properly. The main interrogation is whether retraining could be successful at all, because the deficit exists mostly in advanced modern professions - in 2022, even before the mandatory draft was announced, Putin admitted that the estimated deficit of personnel in the Russian IT sector may reach 1 million people by 2024. It is doubtful that all these employees of manufacturing industries, and other sectors hit by sanctions and hidden unemployment, may be retrained into IT specialists.

Banking sector problems coming to light

In the previous report on the effects of sanctions published in November, it was highlighted that economic difficulties will inevitably translate into problems for Russian banks - as happened in every previous crisis, because industries affected are also key borrowers. It was impossible to tell throughout 2022, because the Russian Central Bank immediately moved to classify banks' accounting reports after Putin invaded Ukraine in February 2022.

Recently however, problems of the banking sector are coming to light. Many banks have recently been publishing their annual financial reports for 2022, and, although most of the large banks recorded profits in 2022 - albeit very small - two of the Russia's biggest banks, VTB (ranked #2 among Russian banks by size of assets) and Alfa Bank (ranked #4) have shown losses totalling nearly 1 trillion rubles, worse than the previous record for losses of 2009 (in the aftermath of the 2008 financial crisis). VTB and Alfa together represent 23% of the total assets of the Russian banking system. Some of the major banks (like Promsvyazbank, one of the top 10 Russian banks) haven't released their financial accounts for 2022 at the time when this report was written, and the Central Bank mentioned in its annual 2022 report released on March 29, 2023, that four unnamed banks required insolvency prevention measures in 2022.

Given the experience of the previous Russian economic crises, major economic difficulties inevitably cause problems for banks with lag time, and the banking sector and the Central Bank have a tendency to cover these problems up to prevent a bank run. It is very likely that the same thing is happening this time as well, and serious problems in the banking sector would again follow the troubles of the real sector. The reports about the overall ability of banks to retain profitability in 2022 despite the crisis shouldn't be taken at face value either. First, profit is a manipulated indicator because it depends on how much reserves banks allocate to cover potentially toxic assets. It happened before in the Russian banking sector that such allocation of reserves was insufficient to paint a brighter picture than reality. Second, profitability is achieved through an aggressive interest rate policy - excessive interest income growth far exceeding the Central Bank interest rate hikes. This is achievable due to high monopolisation of the Russian banking sectors by a handful of state-affiliated banks, and is hurtful to any potential economic recovery.

The ruble weakens despite draconian currency regulations

One of the major sources of fanfare about "Russia weathering the sanctions" in the past year has been the strengthening of the ruble exchange rate - Russia's currency had been labelled as "best-performing in the world", etc. Well, that is predictably over now – the ruble lost about 40% of its value since it peaked in June 2022, and in the past weeks, it made headlines as the worst-performing currency among the emerging markets.

Reasons for the inevitable devaluation of the ruble are obvious. It is not in international demand, not just because of recently introduced draconian currency controls, but also because the Russian economy is small, and doesn't produce internationally competitive goods, except basic commodities. Efforts to switch to national currencies in commercial relations with non-Western countries have failed significantly - to a large extent because companies and banks from countries like India or others simply don't want to deal with rubles. Due to Russia's economic turmoil, the ruble also presents a significant currency risk for any parties who use it. On the background of this - a flip side of Russia not being able to produce competitive goods - Russian imports in the past years have surged, returning to pre-war levels, because Russia has found new ways to import the necessary goods through countries like Turkey, China, Central Asia, and others. That means growing demand for foreign currencies.

Another factor are Western corporate exits from Russia, which turned out to be more stretched out over time than expected, but are still happening - and companies obviously want to convert the cash from sales of their Russian assets into foreign currency, which increases demand for it. Russians are continuously buying currency as a means of savings and moving it abroad - according to the Russian Central Bank, in 2022, Russian individuals have moved $64 billion in cash abroad, a record-breaking amount. That process will go on as long as people with means continue to leave the country.

Generally, the ruble will continue to weaken because of the fundamental flaws of the Russian economic system, and the lack of a competitive economy. It will not have some of the hypothetical upsides for development, since it is impossible to develop competitive export-oriented industries, which can benefit from the weak ruble, in the current environment of international isolation and destroyed investment climate. But the downsides will be clear: the weakening ruble continues to undermine Russians' consumer purchasing power, and thus contributes to weak domestic demand, which, as said above, is currently one of the most important impediments to growth.

Pivot to Asia: partially functioning, but prohibitively expensive logistics

One of Putin's major instruments of mitigating the problems caused by sanctions is the declared "pivot to Asia": increased trade and economic relationships with China, India and other Asian powers which haven't joined the sanctions against Russia and do not intend to. The Pivot to Asia is working to some extent, but only partially. Volumes of trade with Asian countries have surged, but Russia is nowhere near the possibility of receiving similar benefits from relations with Asian countries as it had received in the past from the collective West.

China, India and Asian nations are fundamentally not interested in acting as similar donors in relation to Russia regarding capital, technology, and skills like the West did in the past 30-40 years. Since 2014, Russia has hoped to substitute the loss of access to Western capital markets with massive inflow of investment from Asian countries - but it didn't happen to a significant extent. The only major exceptions were when China wanted to support exports of its own goods and services to Russia and provided loans to finance the procurement of those (like with Novatek's LNG projects).

By the beginning of 2022, cumulative FDI from Asian countries in Russia were exceptionally low: $3,3 billion from China, $2,4 billion from Hong Kong, $0,6 billion from India[6] (according to the Russian Central Bank). There have been no major new investments in Russia from these countries since the beginning of the war.

[6] Central Bank of Russia. "Direct investment in the Russian Federation: balances by instrument and partner country (assets/liabilities)". https://www.cbr.ru/vfs/statistics/credit_statistics/direct_investment/dir-inv_in_country_1.xlsx.

China and India are fundamentally not interested in emergence of Russia as a major international competitor in manufacturing industries. One of the illustrative examples in this regard is a rare case of cooperation between Russia and China beyond just raw materials industry and in high-technology sectors - an attempt to build a joint widebody passenger aircraft, CR929. The project was launched in 2012, and, after many difficulties emerging in the process of its implementation (including China denying Russians the ability to participate in marketing of the aircraft in the Chinese domestic market), the project seems to be collapsing: in the past few months, Russian Deputy Prime Minister Yury Borisov and his successor Denis Manturov have publicly admitted that cooperation on this project is going nowhere, with China drifting towards finding other partners, and Russia's role being reduced from a full-scale partner to a simple supplier of some technologies and component parts[7].

What is left - and this is what makes the bulk of the impressive "trade turnover" numbers often cited by Russian officials as proof that "the pivot to Asia is working" - is increased supplies of cheap natural resources to Asia. In Sino-Russian trade, over 70% of Russian exports are oil, petroleum products, natural gas, coal and roundwood; three quarters of Chinese exports to Russia are machines, equipment, consumer goods and other goods with higher added value. The enormous $25-30 dollars per barrel discounts for Russian Urals crude come from the Asian market. According to Russian coal exporters, they have to offer discounts as much as 50% to the price of Australian coal to be able to sell Russian coal in Chinese and other Asian markets.

Take the much-celebrated "Power of Siberia" gas pipeline. Although the price of gas supply from Russia to China is not publicly disclosed, it can be very easily calculated given the publicly announced volume of gas supply through the pipeline in 2022 (15,5 bcm), and the amount of money paid for it ($3,98 billion, according to China General Administration of Customs). The resulting figure is the average gas price of $257 per thousand cubic meters (tcm); in 2022, the average gas price in Europe – TTF gas hub in the Netherlands – was $1365 per tcm, while the average price of LNG imports in Asia was over $1200 per tcm. Russia not only supplies China with the cheapest gas in the world, but also most likely does so at a significant loss. When the contract for gas supplies via "Power of Siberia" was signed in 2014, it was announced that the price of gas supply would be within the $350-380 per tcm range; at the time, Gazprom applied for the government and State Duma to zero out nearly all the taxes for the project (which was done), openly saying that, without such major tax exemptions, supplies of gas via "Power of Siberia" would not be profitable. But in 2022, the price of supply was nearly 30% lower than even that level. Gazprom doesn't disclose its financial results - and has never disclosed the net results from gas sales to China even before the war - but it is unlikely that Russia makes any profit from that supply (and definitely no tax revenue for the federal budget).

The new gas pipeline infrastructure to China, which Russia currently talks about - most notably the "Power of Siberia-2" pipeline from Eastern Siberia to China - will cost not less than a hundred billion dollars, and the route of gas transportation from Urengoy (the main gas producing hub in Western Siberia) to China will in any case be well in excess of 4,000 km (the current "Power of Siberia" route is 3,200 km). Russia will have to negotiate a very favorable gas price with China to make such supplies economically viable - which would be very hard to achieve. This is probably the reason why Russia permanently keeps announcing some sort of "agreement" reached with China on "Power of Siberia-2", but the Chinese side never confirms it - as happened during Xi Jinping's visit to Moscow in March 2023.

[7] TASS. "Denis Manturov: next year will be transitional to a new model of industrial development", December 28, 2022. https://tass.ru/interviews/16699423. Accessed June 1 2023.

The other major problem is that complicated logistics of trade between the European part of Russia (where most of the population and economic activity is concentrated) and countries like China or India makes trade very difficult. The Russian Central Bank lists costly logistics of re-orientation towards trading with Asia as one of three major pro-inflationary factors (the other two being deficit fiscal spending and increasing labour costs due to shortages of skilled labour). This is one of the reasons why trade with India never gained traction: India mostly keeps buying Russian oil with discounts, but other than that, not much has happened: Indian exports to Russia amounted to only $2,5 billion in 2022. It is obviously too difficult and too expensive to ship Indian goods to Russia.

Russia's dream of massive substitution of U.S. dollars and the Euro in international transactions with Chinese yuan or Indian rupees also hits barriers because of problems with free convertibility of these currencies abroad.

Generally, cooperation between Russia and Asian countries like China and India has many systemic obstacles, and won't be able to act as a comparable substitute of economic relations with Europe and the other Western countries.

Circumventing sanctions: successful, but for how long?

The one area where Putin has truly been relatively successful in the past year is circumventing sanctions through third countries. This is discussed here in a wide context: not only trade in sanctioned goods themselves, but also critical imports of industrial and consumer goods which are not under sanctions, but were lost due to Western businesses pulling out of the Russian market. Parallel imports, for instance, have exceeded $20 billion in 2022.

Russia had substituted a lot of lost direct Western imported goods through countries like Turkey: Turkey's exports to Russia have increased by 62% in 2022 (to $9,3 billion), in January-April 2023 - by 47% (to almost $1 billion per month), according to Turkstat[8].

Russian exports to the United Arab Emirates in 2022 had increased by 71% to $8,5 billion, according to the Russian Deputy PM Denis Manturov – clearly, there is hardly any additional demand for Russian goods in the UAE to that extent, and the surge of Russian exports largely reflects trading schemes aimed at circumventing sanctions through Emirati traders.

The Free Russia Foundation produced a report in January 2023 titled "Effectiveness of U.S. sanctions targeting Russian companies and individuals" based on detailed trade data from 2021-2022[9]. According to the report, Russia established alternative routes fairly quickly with imports of dual-use and controlled commodities now exceeding pre-war levels. Data shows that countries most actively facilitating circumvention of wartime sanctions by Russia include: China, Turkey, Cyprus and the UAE. Central Asian countries, such as Georgia and Armenia, also play a significant role in sanctions circumvention.

[8] Turkish Statistical Institute. "Foreign Trade Statistics, April 2023". https://data.tuik.gov.tr/Bulten/Index?p=Foreign-Trade-Statistics-April-2023-49632. Accessed June 1 2023.
[9] The Free Russia Foundation. "Effectiveness of U.S. Sanctions Targeting Russian Companies and Individuals", January 30, 2023. https://www.4freerussia.org/effectiveness-of-u-s-sanctions-targeting-russian-companies-and-individuals/. Accessed June 1 2023.

The good news about all this is that the loopholes are relatively narrow. Just a handful of countries - Turkey, the UAE, Central Asia - allow most of these circumvention schemes, which means that such schemes are vulnerable to diplomatic pressure on the relevant countries - and partial results in this regard have already been achieved by the European Union and the United States, with some of the loopholes closing.

Yes, it is true that Russia is developing a major channel of sanctions evasion and participation in international trade through China, which became Russia's major trading partner. In 2022, mutual trade turnover between Russia and China hit a record-breaking $190 billion. China is much less vulnerable to Western diplomatic sanctions as compared to Turkey, UAE or Central Asian countries, and became a source of critical imports of items like semiconductors, as becomes clear from the detailed trade data analysis like that of the above-mentioned Free Russia Foundation report.

However, logistically, trading with China is difficult. Most of the population and economic activity in Russia is concentrated in the European part of the country; trade is marred with high transport costs and logistical bottlenecks. This is why Turkey, not China, is the favoured Russian route for sanctions circumvention: while in absolute terms Russian imports from China still dominate, in relative terms, Turkey is rapidly catching up. In 2021, Russian imports of goods from China exceeded imports from Turkey by a factor of 12; this has shrunk to just about 8 in the first quarter of 2023.

Table 4. Russian imports from China and Turkey (sources: China General Administration of Customs, Turkstat)

	2022	January-March 2023
Russian imports from China, year-on-year growth, %	12,8 %	47,1 %
Russian imports from Turkey, year-on-year growth, %	62 %	67,8 %
Russian imports from China, total volume, billion USD	76,12	24,07
Russian imports from Turkey, total volume, billion USD	9,34	3,1

Turkey is viewed by many businesses in Russia as the favourite route for imports of critical goods, component parts and technology products, because of its geographical proximity to European Russia and cheaper logistics, and also because Turkey is the easiest way to get "grey" imports of European goods - shipping them through China is significantly more complicated.

Conclusions

The economic situation in Russia significantly worsened in the early months of 2023 due to Western sanctions, exactly as predicted. The ongoing budget crisis is the main thing to monitor in 2023 - Russian financial reserves are set to expire soon, while there are little other sources of financing the economic recovery, except through government funds, in the current economic model.

Although some of the economic indicators have improved since the worst months of the Fall of 2022, there is actually no recovery going on - more like a stagnation. Some positive indicators than can be seen in the coming months will mostly reflect the comparisons with the low base of April-May 2022, rather than the actual improvements of the economic situation. There are no major factors contributing to any potential significant improvement of the situation - private investment is depressed, government funds are running out, foreign investment is not coming, consumer demand is down, the Central Bank is forced to keep interest rates high due to inflation picking up again, the government is raising taxes to solve the budget deficit problem, the pivot to Asia is not truly working, and a key new factor putting pressure on the economy is the shortage of skilled labour caused by wartime mobilisation and the mass exit of skilled workforce from the country.

In short, sanctions are working, and the Russian economy has hit severe difficulties in 2023, just as predicted. The key area of concern though is the relatively successful circumvention of Western sanctions by Russia through third countries like Turkey, UAE, China and others - which requires additional diplomatic and other measures from Western democracies to close that loophole.

Key policy recommendations in this respect:

- The West should recognise serious and progressing damage done by sanctions to the Russian economy, and mute erroneous messaging about “sanctions not being too effective”, which emboldens the Kremlin’s propaganda and disinformation efforts aimed at Western public opinion and policymakers;

- Key emphasis at present should be put on closing the loopholes for Russia for sanctions circumvention, including diplomatic work with Turkey, UAE, Central Asian countries, Georgia, Armenia, etc.;

- Detailed studies should be launched on the specific effects of sanctions on various sectors of the Russian economy, aimed at improving the efficiency of the sanctions mechanism, and on shutting down various shadow schemes of sanctions evasion (like the oil embargo evasion with “shadow fleet” and Asia-based trading firms);

- Russia’s mounting budget crisis is the key thing to watch in the near future; it has a direct connection with all the previous rounds of sanctions, and particularly the oil embargo;

- Options should be analysed for imposing further sanctions on sectors which still deliver significant export revenue to Russia - non-ferrous metals, Rosatom, precious metals, etc.

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