The impact of sanctions on the Russian economy. 
Assessing the consequences of the Ukrainian conflict

Julien Vercueil
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Author

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Observatoire

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Introduction

The military escalation in the Ukraine came as an unexpected tragedy. In March 2014, Western powers reacted to Russia’s annexation of Crimea by imposing a first series of sanctions. A chain of subsequent events, including increased fighting in the south-east of Ukraine, Moscow’s support of the Donbass insurgency, the downing of the Malaysian Airlines plane carrying 298 civilian passengers (attributed by West to pro-Russian separatists), all led to a second wave of sanctions being imposed. In September 2014, despite a cease-fire agreement – from the outset repeatedly violated on the ground -, the absence of any settlement of the conflict caused a third string of sanctions being rolled out against Russia. What impact has this had on the economy of the country?

During the initial phase (March–April 2014), most commentators claimed that the sanctions had no immediate consequences on Russia’s economy. During the second phase (May-August 2014), views started to differ: while some continued to deny any significant impact, others started to point to the adverse effect these measures are having on the economy of the European Union, and others finally predicted a potentially significant – and negative – impact on the Russian economy.

It has to be noted, however, that these views rarely place the sanctions into context, which would be necessary to distinguish three different processes that compound the Western measures and influence their impact: the structural downturn of the Russian economy prior to the events in Ukraine (Vercueil (2014a); the initial impact - i.e. apart from the sanctions - of the escalation of the situation in Ukraine on the Russian economy; the counter-measures taken by Russia against the countries which imposed the sanctions – in particular the one year embargo on fresh produce from the European Union, Canada, Australia and the United States, targeting their agro-food industries.

In order to ensure the analysis is as comprehensive as possible, given the limitations of geopolitical uncertainty and the systemic nature of the impact of a military crisis at the heart of Europe, it is necessary to list all the dimensions of the economic impact of the conflict, keeping in mind that these cannot be entirely separated from one another. To this end, we have divided this paper into four parts. The first part focuses on the macroeconomic context. The second proposes an assessment of the immediate impact of the military escalation on the ground. The third looks at the role of the sanctions as well as their scaling-
up, followed by the Russian authorities’ response to these. In the fourth part, we propose three quantitative scenarios likely to play themselves out as a result of the Ukrainian conflict. The structural impact of the events which unfolded since the beginning of 2014 in Ukraine will only be mentioned in the conclusion.
The macroeconomic context is marked by a structural showdown

Since the crisis of 2009, the Russian economy has to a large extent veered off the course initially charted in “Strategy 2020”. This framework document which outlines the broad macro-economic policy of the country for the decade 2010-2020 was commissioned in 2007 by the Russian President from a panel of experts and researchers. It led to the formulation of three possible scenarios for the Russian economy. The most optimistic of these was based on a plan to modernise the economy which would significantly increase investments above its long-term average (to 30% of GDP, compared to 20% before), driving productivity up (from +5 to +10% per year), which in turn would lead to a sustained GDP growth rate of 6 to 7%. Under these circumstances, the move towards catching up with living standards of the West would become viable by 2030/2040.

This positive scenario did not come true. In the aftermath of the global financial crisis, GDP dropped by 7.8% in 2009, despite a fiscal stimulus totalling 11% of GDP for the year. The subsequent economic upturn, supported by a rapid rise in global commodity prices, was not enough to regain the expected momentum. Growth reached 4.5% in 2010 and 4% in 2011. In 2012, the first signs of a new slump started to be felt (+2.5%), confirmed by sluggish growth in 2013 (+1.3%).

At the beginning of 2014, the growth deficit cumulated since 2009 was 25 GDP points off the highest targets set out in “Strategy 2020”. The growth outlook for the year hovered at a far too low level for initial targets to be reached, even after these had been revised downwards¹ (INP RAN, 2014). But above all, the ongoing dynamics showed signs of a downwards trend, as the main drivers of growth seemed to be running out of steam.

There is no consensus over how to explain the downturn. Analysts mainly diverge on the temporary nature, as opposed to the structural nature of the problem. Those in support of the first opinion argue that it can be explained by some aspects of the economic policies adopted by Russia. In their view, monetary policy of the central bank is to blame: by maintaining interest rates high and the exchange rate of the rouble almost unchanged, it is discouraging

¹ In his address at the Saint-Petersburg forum in June 2013, Vladimir Putin mentioned growth rates of between 4 and 6% per year.
overall demand (Sapir, 2014, p. 106-107). Other research points to fiscal policy, which in a bid to curb the public account deficit, is excessively insulating structural funds by limiting spending, thus introducing problems of sequencing of large-scale infrastructure projects, in turn placing a drag on growth (Shirov, 2014).

Without challenging the relevance of these cyclical factor-based analyses, our research focuses on some structural aspects at play. When analysing the slowdown of drivers of extensive growth (working population, capital assets, number of hours worked) and what we could call “imported growth” (through the rising global oil price), we suggest that the main challenge lies in the difficulty to raise productivity in a sustained and systemic fashion, a precondition for effectively preventing export and tax revenue from being concentrated in a small number of sectors. This analysis downplays the capacity of public investment and monetary policy decisions alone to reverse these macro-trends. It highlights as a key objective the need for integration within the national productive fabric, of technologies and operational patterns that are likely to modernise the production infrastructure. As a result, we would consider public policies that would boost private investment, whether national or foreign (Vercueil 2014a, 2014b, 2014c).

The incapacity of the Russian economy to modernise itself at a desirable pace comes at a cost: its economic situation remains heavily dependent on aspects beyond the President’s control. Two variables can illustrate this point: the price of oil per barrel and the economic performance of the European Union, Russia’s main trade partner. A simple econometrics study conducted on quarterly data for the period 2003-2012 shows that, taken together, these two variables explain 75% of the variability of Russia’s GDP growth (Vercueil, 2012).

At the outset of 2014, the long-term growth outlook of the Russian economy was thus not very optimistic. International bodies estimated an average growth of 2 to 3% per year, instead of the 5 to 6% required for the initially forecasted recovering trend (IMF, 2013, OCDE, 2014, World Bank, 2014). This is the context in which the Ukrainian escalation unfolded.
The annexation of Crimea and the escalation of the Ukrainian conflict in themselves have negatively impacted the Russian economy

The economic repercussions of the annexation of Crimea can be analysed along two major timeframes: the “first round” effects, which are those linked to the immediate reaction of economic players to the geopolitical developments, and the “second round” effects, which are the indirect consequences of these very same reactions.

**First round effects**

The sudden rise of the level of conflict in the region, the regional leader’s proclamation of Crimea’s separation from Ukraine, the latter’s decision to become part of Russia, President Vladimir Putin’s authorisation of the use of the Russian Army on the Ukrainian territory are all events that have suddenly heightened the level of geopolitical uncertainty. The first noticeable consequences were a four-time increase in capital exports from Russia during the first quarter of 2014, reaching 51 Billion dollars at the start of April, of which 20 Billion acquired by non-banking entities in foreign liquid currency (IMF, 2014, p. 14). This movement led the Moscow stock exchange to plummet, due to its large exposure to international capital flows. The 3rd of March 2014 alone, the MICEX index lost 13.8% - i.e. 60 Billion dollars – against the backdrop of a three-time increase in trade volumes. Trading of several stocks had to be suspended after their values fell by more than 20% during the course of the day. Capital flows and the fall of the stock market had fuelled tensions on the foreign exchange market and massive speculation against the rouble had to be curbed by a large-scale selling-off of foreign denominations by the Central Bank: 11.3 Billion dollars on 3 March, which is close to the maximum recorded at the height of the financial crisis (19/01/2009, 15 Billion) (World Bank, 2014, p. 24).

However, these actions couldn’t prevent the fall of the rouble, which during the first quarter of 2014 had lost 8% of its value compared to its main counterparts. This explains the hike in the interest rate, also on 3 March, from 5.5 to 7%. It was later brought to 7.5% by the end of April and 8%, by the end of July 2014. This increase was the result of the combined effect of speculation against the rouble, the excessive selling-off of overpriced foreign currencies
and the need to withstand inflationary pressures caused by the increase cost of imported goods. At the same time, through the effect of this increase on the structure of investment income, the Central Bank attempted to maintain capital within national borders.

Table 1. Decisions to increase interest rate of the Russian Central Bank: January – October 2014

<table>
<thead>
<tr>
<th>Date</th>
<th>Interest rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before 03/03/2014</td>
<td>5.5%</td>
</tr>
<tr>
<td>03/03/2014</td>
<td>7.0%</td>
</tr>
<tr>
<td>28/04/2014</td>
<td>7.5%</td>
</tr>
<tr>
<td>28/07/2014</td>
<td>8.0%</td>
</tr>
</tbody>
</table>

Source: Russian Central Bank.

Second round effects

The fall of the rouble’s exchange rate is not in itself necessarily detrimental to the Russian economy. It might in the short term impoverish the Russian economic players by decreasing their international purchasing power and the international value of their assets (for the rouble-denominated part of it). But it also boosts price competitiveness of domestic production which could lay the grounds for growth to rebound, as was the case in 1998-1999.

In fact, the problem really lies in the capacity of the economic fabric to respond to the depreciation and monetary policy: with high price elasticity of imports, the rise in export prices could encourage domestic production and the net impact on productive activity could be positive. If this is not the case, the higher prices would only further drain domestic revenue. It would merely fuel inflation without boosting production. In addition, higher interest rates caused by the pressure on the rouble could depress overall demand hitting consumption and private investment. This is a way to contain inflationary pressure linked to depreciation as well as demand for domestic production. The net effect on economic activity could once again be recessionary.

2 Price elasticity is the relation between the relative variation of quantities and the relative variation of price. For imports, it is generally expressed by the following ratio: $e_{(M/t)} = (\Delta M/M)/(\Delta t/t)$, where $M$ represents the value of imports expressed in national currency, $t$ the exchange rate of national currency compared to the basket of currencies of trade partners, $\Delta$ the variation of size over the period considered. The sign expected from elasticity of imports at exchange rate is negative if the exchange rate is linked to uncertainty (the international currency being the reference).
Finally, the business community can anticipate some of these developments. Uncertainty about the future increases the share of precautionary savings as part of revenue, supported further by the higher interest rate. In an economy like Russia’s where consumption is the main driver of growth (Vercueil, 2014a), the consumer confidence index is a key factor for the economy. If this deteriorates, the slowdown becomes home-grown even though it might have been fuelled from outside by the effects of the depreciation. As early as 10 March, the implication of these second round effects led the Research institute BOFIT to drop its growth outlook for Russia by one point (Rautava, 2014, p. 5).

**Which second round effects are visible in Russia?**

During the first half of 2014, consumption and investment reacted in different ways. Consumption continued to grow, albeit at a slower pace than before (+2% on average in the first quarter according to Rosstat), which offset the drop in investment (-2.8%) and avoided the recession. At the same time, the rouble’s depreciation was cushioned by a substitution to imports which, at a time when exports were slowing down, allowed foreign trade to contribute positively to growth. As a whole, the economy had globally resisted to the deteriorated geopolitical environment during the first half, with a GDP growth rate estimated at 1% per year (INP RAN, 2014). Conversely, inflationary pressure increased, the annual rate of consumer price increase stood at 8%, a far cry from the 5% Russian Central Bank target set at the end of 2013 (Central Bank of Russia, 2013). In a context of slow growth, fast pace inflation is not good news as it points to variations in relative prices, i.e. an increase of disparities in standards of living between various classes of the population.

These disparities are also apparent in the various sectorial situations. While agriculture production remained upbeat, the automobile industry, symbol of the recovery of the Russian economy in the first decade of this century, recorded a slump in the first half, with a 7% drop in sales. Month after month, the market outlook for the year had to be revised downwards, causing the leader Avtovaz to lay off 11 000 workers between January and July, and announcing another 25 000 job losses by 2020. If we take into account the knock-on effect this could have on the supply network which is still building itself up, a sharp fall in automobile production in Russia would certainly have a negative impact on the manufacturing industries, although very dynamic until now. In a context

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of rising inflation, this would soon lead to social hardship in production regions (Central Volga basin, Saint-Petersburg, Kaluga, and some areas near the Moscow region).

Following the crisis in Crimea, the election of Petro Poroshenko as President of the Republic of Ukraine and the fact that the new executive did not show signs of planning any explicit military campaign to gain back control over the peninsula, tensions eased for some time (Zhavoronkov, 2014a), decreasing geopolitical uncertainty and even leading to a reversal of trends on financial markets between March and July (graph 1). But from May onwards, the military escalation resumed in the Donbass and its impact on the economic situation further prolonged the events of March.
Sanctions and counter-sanctions in this deteriorated environment led to stagflation

The chronology of international events related to the Ukrainian conflict (box 1) shows three major periods, which can each be broken down into several phases in terms of its consequences on the financial markets (graph 1): from January to mid-June, uncertainty was fuelled by the situation in Crimea (period 1). From June to the end of August, it was caused by the events in the Donbass (period 2). From September, the economic consequences of the sanctions seem to have captured the attention of economic players (period 3).

Inside each of these periods, three phases can be identified: during the first, uncertainty over the possible consequences of events unfolding gained the financial markets. Tensions mounted and market opinion came close to a sharp downturn (phases 1.X on graph 1). A decision or a particular event occurred, crystallised fears and caused an outflow of capital. This movement translated into a sudden fall in the MICEX index and a collapse of the rouble (crisis X on graph 1). The third phase shows an easing of apprehensions, economic players attempting to return to the market, expecting to regain part of the ground lost in the meanwhile. This interrupted, or even reversed, the trend (phases 2.X on graph 1).

**Box 1. Chronology of sanction imposed by the OECD countries on Russia (as on 2 October 2014)**

**17 March:** Canada, the United States and the European Union (EU) ban Russian and Crimean political leaders from travelling to their territories. Japan suspends ongoing discussions on visas, military, space and investment issues. Australia imposes financial sanctions and a travel ban on Russian officials.

**April:** Albania, Island, Montenegro and Ukraine impose the same restrictions as those of the EU.

**28 April:** The United States bans 17 companies and several Russian officials from doing business on its territory. The EU bans 15 other Russian leaders from entering its territory.
<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>17 July</td>
<td>The United States limits access to investments with maturity term over 3 months for Rosneft and Novatek and two banks Gazprombank and Vneshekonombank.</td>
</tr>
<tr>
<td>24 July</td>
<td>Canada expands sanctions to Russian companies from the arms industry and the energy and financial sectors.</td>
</tr>
<tr>
<td>25 July</td>
<td>The EU expands sanctions to 18 additional companies and 15 officials.</td>
</tr>
<tr>
<td>29 July</td>
<td>The United States limits access to investments with maturity term over 3 months for the Bank of Moscow and Rosselkhozbank.</td>
</tr>
<tr>
<td>30 July</td>
<td>The EU extends sanctions to 8 additional companies and officials.</td>
</tr>
<tr>
<td>31 July</td>
<td>The EU extends sanctions to the Russian public financial sector. Trade restrictions are imposed on companies from the energy and defence sectors.</td>
</tr>
<tr>
<td>5 August</td>
<td>Japan freezes assets of individuals and groups having contributed to the separation of Crimea from Ukraine. The EBRD freezes funds intended for new projects that form part of its engagement with Russia, primary beneficiary of these funds. The EIB does the same.</td>
</tr>
<tr>
<td>12 August</td>
<td>Norway imposes similar restrictions on Russia as the EU.</td>
</tr>
<tr>
<td>14 August</td>
<td>Switzerland expands its ban imposed following the annexation of Crimea to 26 additional people. Sberbank, VTB, Vneshekonombank, Gazprombank and Rosselkhoz are required to request permission before issuing long term financial instruments on Swiss territory. Ukraine expands its sanctions to 172 individuals and 65 entities.</td>
</tr>
<tr>
<td>28 August</td>
<td>Switzerland joins the EU’s newly imposed sanctions to its list.</td>
</tr>
<tr>
<td>12 September</td>
<td>The United States toughened its sanctions and extends them to Sberbank, Rostech, Gazprom and Gazpromneft, Lukoil, Surgutneftegaz and Rosneft. It also suspended technology transfer related to deep-water and shale gas exploration.</td>
</tr>
<tr>
<td>24 September</td>
<td>Japan bans the issuance of bonds by Sberbank, VTB, Gazprombank, Rosselkhozbank, and VEB, and toughens sanctions on Russian defence exports.</td>
</tr>
</tbody>
</table>
The impact on financial markets is exacerbated by the fact that since 2006, Russia no longer imposes significant restriction on international movement of capital. The size and the structure of its financial markets make them vulnerable to variations in the dominant mood of the capital markets (Vercueil, 2014a, Ministry of Finances of Finland, 2014). Capital flows slowed down in the second quarter, reflecting a lull also due to seasonal factors (graph 1, phase 2.1.), but the expansion in July of sanctions to the financial sector brought observers to raise the following two questions about the reaction of the financial markets (Dolgin and Orlova, 2014):

- will investors “turn their backs” on all Russian businesses, or will they distinguish between those under sanctions and those who are not? Initially, blanket treatment prevailed, but after four weeks of wait-and-see, Western banks resumed financing some Russian companies in foreign currencies⁴.

- following the sanctions, can Russian institutions rapidly and at the same cost obtain other sources of financing from Asian markets? Although the events of March 2014 clearly renewed economic reorientation towards Asia as official Russian foreign policy, private actors who have no historic links with Asian financial markets are grappling to make such a shift. Apart from the prepayments

⁴ Bloomberg, 15/08/2014.
Rosneft obtained during the summer from its Chinese clients\textsuperscript{5}, this conversion will require time, something that Russian companies under their current financial commitments cannot necessarily afford. In the meanwhile, these entities are turning towards the State for alternative sources of financing.

After another tightening of Western financial sanctions in September (box 1), risk of a credit crunch increased, accelerating capital outflows and causing a new drop in the rouble (graph 1, phase 1.3 and crisis 3), \textit{20\%} down in comparison to its level in the beginning of the year. Some observers consider that 150 Billion dollars are required to compensate for the effects of the gradual isolation of the Russian economy from Western capital markets\textsuperscript{6}. It corresponds to predictions made since July concerning capital exports for the entire year (IMF, 2014, Dolgin and Orlova, 2014). During the second half of 2014, Russian private entities are required to settle 73 Billion of the principal of their foreign debt (Zlotowski, 2014, p. 6). The fall of the rouble increases this expense and encourages more conversion of assets into foreign currency, further exacerbating the process. Early October, the Ministry of Economy confirmed the accelerated capital flows, mentioning a total of 120 Billion dollars for the year 2014\textsuperscript{7}. The figure might turn out to be too optimistic if the trends observed in the first few weeks of October are confirmed.

The economic and financial stress suffered by the major economic players in Russia prompted the Russian authorities to become more involved in the economy. In June, Vladimir Putin spoke of the need to inject some 50 Billion dollars to recapitalise Gazprom, before it publishes its first quarterly losses since 2008, due to a delay in Ukrainian payments. Late July, Igor Sechin, CEO of Rosneft, proposed five options to the Russian authorities to enable its company to withstand the shortfall of Western financing. One of those was to issue the equivalent of 41.6 Billion dollars in rouble, drawn from the national welfare fund to erase part of its foreign debt, estimated at 72 Billion\textsuperscript{8}. By the end of August, Rosneft and Lukoil obtained financing from Promsvyazbank, one of the main Russian\textsuperscript{9} private banks. At the beginning of September, the government announced a 6 Billion dollar capital increase for VTB and Rosselkhozbank\textsuperscript{10}.

On 22 September, the Finance minister declared that Rosneft would receive between 2 and 4 Billion dollars of public money in the form of bonds financed from national welfare funds. And so would Novatek, requesting 2.5. This was when the Yevtushenkov affaire broke out.

After a brief respite and hopes that the situation would improve following the cease-fire signed in the beginning of September, uncertainty soon returned to the financial markets as a result of what clearly indicates a shift from the authorities towards tighter State control over the economy. By the end of September, amid repeated violations of the cease-fire in the Donbass and dwindling confidence in the markets, the Russian Central bank in a statement denied any rumours concerning a reinstatement of administrative restriction on capital transfers. During the first three weeks of October, support for the rouble absorbed 13 Billion dollars of exchange reserves, i.e. the equivalent of one month’s worth of oil exports. Rating agencies downgraded Russian sovereign debt, causing a first rise of interest rate spreads on Eurobonds.

For the most part, the Western sanctions have affected the Russian economy through the financial markets and banking system. Initially, due to their gradual nature and the compensatory steps taken by the government, the macro-economic consequences of these sanctions were limited: contrary to expectations, second-quarter growth was +0.25% on an annualised basis, not negative. However, the recent development of the situation seems to vindicate the pessimistic projections that have been building for the second half of the year: in September, the growth predictions for 2014 ranged between -1% (Ministry of Finances of Finland, 2014, p. 12), and +0.5% (Ministry of Economic Development of the Russian Federation, World Bank), with the International Monetary Fund counting on a virtual stagnation (+0.2%14) and Coface on zero growth (Zlotowski, 2014, p. 9).

The continuation the rouble’s depreciation and the counter-sanctions initiated by the 6 August 2014 presidential decree fuelled the inflationary recovery. The products affected by the Russian embargo on imports—the list of which varied during the summer—encompass 30% of the country’s meat and vegetable

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11 On 18 September, the surprise arrest of Vladimir Yevtushenkov was announced. He is the owner of Sistema, the holding company controlling Bashneft, a private oil company and competitor of Rosneft. The reasons and conditions of this arrest were broadly commented in Russia. Comparing it to the Yukos affair, some commentators consider that Bashneft’s assets, one of the best performing Russian companies in the oil industry, risks falling in the hands of Rosneft (Bloomberg, 6/10/2014).


13 Bloomberg, 20/10/2014.

consumption and 40\% of its consumption of fresh produce. This means that in the short term, the economy cannot find replacements in the same quantities and at the same prices from Latin America or Asia (Ministry of Finance of Finland, 2014, p. 10). The shortage of these products—the undoubtedly temporary substitution can also be carried out so as to benefit local production, but the waits then become longer—combines with the inflationary effects of the rouble’s depreciation, which are more significant as this fall intensifies, to plunge the economy into a period of stagflation.
What are the scenarios for the coming months?

A number of recent publications consider development scenarios of the geopolitical situation surrounding Ukraine and deduce from it the consequences on the situation of Russia and the European Union, both on a sector-based level (Holz et al., 2014; IMF, 2014; Ministry of Finance of Finland, 2014; Zlotowski, 2014), and on a macro-economic level (World Bank, 2014). It should be noted that among these studies, those that address the financial system do not rule out the possibility of a systemic financial crisis leading to a default by Russia on its external bonds in case the geopolitical situation deteriorates acutely and causes a new escalation of sanctions (IMF, 2014; Zlotowski, 2014). Here we are limiting ourselves to a short-term analysis of a few key variables (financing, exchange rate, inflation, investment, consumption, production, federal budget, employment) in a timeframe that does not extend beyond 2015. Within this framework, we are studying three possible development scenarios.

The first scenario ("de-escalation") imagines a calming down on the military and diplomatic fronts between Russia and Ukraine on the one hand and between Russia and the Western nations on the other. The second scenario ("stalemate") supposes the continuation of the current situation: a real and yet not real cease-fire that makes the Donbass into an additional frozen conflict in Eastern Europe, with military positions stabilising on a front line that is susceptible to clashes but lacking in major offensives. Under these conditions, no improvement in the relations between Russia and Ukraine is foreseeable, and the sanctions are upheld as is throughout the scenario, along with counter-measures on the Russian side. The third scenario ("conflict"), refers to a deterioration of the situation, with an aggravation of conflicts by the reaction of the Western powers due to the worsening of the sanctions. Sporadic interruptions in gas deliveries would create a gas crisis in Europe and would deprive Gazprom and the Russian government of part of the revenues from these provisions. Thus a diplomatic and economic escalation would be a reaction to the military escalation in the field.

Table 2 elaborates on these scenarios in four stages. The first stage formulates hypotheses on the development of the diplomatic and military situation. The second stage expresses these hypotheses in terms of sanctions, by the end of the simulation. The third and fourth stages deduce from these stages development scenarios on macro-economic scales that will be treated as exogenous variables in our exercise. The endogenous variables are the development of the fiscal balance and the progression of growth, through the balance between employment and economic resources.
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#### Table 2. Development scenarios for the situation in Russia (late 2014–early 2015)

<table>
<thead>
<tr>
<th>Stage 1. Development of the military and diplomatic situation</th>
<th>De-escalation</th>
<th>Stalemate</th>
<th>Conflict</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compromise between Ukrainian authorities and separatists</td>
<td>Freezing of positions in the field</td>
<td>Widespread resumption of combat in the Donbass</td>
<td></td>
</tr>
<tr>
<td>Agreement on resolution of Crimea situation over time</td>
<td>Regular violations of cease-fire</td>
<td>Russian army re-engages in the Donbass</td>
<td></td>
</tr>
<tr>
<td>Normalisation of Ukraine-Russia relations</td>
<td>No progress in the resolution of the Crimea situation</td>
<td>Western logistical support for Ukrainian troops in the field</td>
<td></td>
</tr>
<tr>
<td>Appeasement of EU and USA–Russia relations</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stage 2. Sanctions and counter-measures (2014–2015)</th>
<th>Gradual decrease in Western sanctions against Russia, starting with sanctions on the financial system</th>
<th>Upholding of European sanctions and Russian counter-measures on imports</th>
<th>Broadening of sanctions in the energy sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gradual lifting of the Russian embargo on Western fresh produce</td>
<td>egasus uncertainty continues to weigh on consumption</td>
<td>Worsening of the crisis of external financing of the banking sector in Russia</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Resumption of international demand for Russian raw materials</td>
<td>Stagnation of production in the energy sector</td>
<td>To restrain the rouble’s fall and faced with the ineffectiveness of the increase in interest rates, restrictions on the rouble’s convertibility imposed by the Russian Central Bank</td>
</tr>
<tr>
<td></td>
<td>Resumption of international funding of Russian companies</td>
<td>Continuation of slowdown of foreign trade</td>
<td>Sharp increase in public spending, funded by money creation</td>
</tr>
<tr>
<td></td>
<td>Gradual resumption of entering foreign direct investment</td>
<td>Continuation of capital flight and strains on the rouble</td>
<td>Drop in export revenue of major Russian hydrocarbon companies</td>
</tr>
<tr>
<td></td>
<td>Resumption of Russian imports of fresh produce from Western countries</td>
<td>Pressures for more public investments in Crimea</td>
<td>Noticeable drop in household consumption related to an anticipation of the worsening of the situation in Europe and Russia</td>
</tr>
</tbody>
</table>

**Note from the Observatoire franco-russe, n°9, November 2014**
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Stage 4. Quantification of impacts on key variables (estimates of changes in 1st half of 2015 compared to 1st half of 2014)

<table>
<thead>
<tr>
<th></th>
<th>De-escalation</th>
<th>Stalemate</th>
<th>Conflict</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Consumption: resumption</td>
<td>(+2% to +7%)</td>
<td>1. Consumption: erosion (-2%)</td>
<td>1. Consumption: drop (-10%)</td>
</tr>
<tr>
<td>2. State budget: upholding of recent spending dynamics</td>
<td>(+5%), stagnation of revenue</td>
<td>2. State budget: strong increase in spending (+15% to +20%), reduction of revenue due to economic slowdown (-10%)</td>
<td>2. State budget: strong spending stimulus funded by money creation (+20% to +30%), drop in tax revenue (-20% to -30%)</td>
</tr>
<tr>
<td>3. Rouble exchange rate: recovery (+15%)</td>
<td></td>
<td>3. Rouble exchange rate: trailing 2014 trend (-10% to -20%)</td>
<td>3. Rouble exchange rate: sharp drop (capital flight: 10% and collapse of FDI) before restrictions/convertibility (-20% to -30%)</td>
</tr>
<tr>
<td>4. Interest rate: return to pre-crisis levels</td>
<td>(+5.5%)</td>
<td>4. Interest rate: continuation of strains on RCB (8% to 9%)</td>
<td>4. Interest rate: sharp increase and then restrictions/convertibility (10% to 15%)</td>
</tr>
<tr>
<td>5. Investment: stagnation</td>
<td>(+0%)</td>
<td>5. Investment: acceleration of 2014 drop (-5%)</td>
<td>5. Investment: sharp drop related to intensification of uncertainty (-20%)</td>
</tr>
<tr>
<td>6. Imports: return to pre-crisis dynamics</td>
<td>(+4%), exports: steady (+0%)</td>
<td>6. Imports: drop related to fall of rouble and restrictions (-10% to -15%), exports: erosion (-5%)</td>
<td>6. Imports: sharp drop related to restrictions (-20% to -30%), same for exports (-20%)</td>
</tr>
<tr>
<td>7. Inflation: upholding of 2013–2014 pace, propelled by demand and supply-side constraints</td>
<td>(+8%)</td>
<td>7. Inflation: slight stimulation, propelled by supply-side constraints and rouble’s depreciation (+8% to +10%)</td>
<td>7. Inflation: sharp rise despite partial price control (+20% to +25%)</td>
</tr>
</tbody>
</table>

Source: prepared by the author.

The hypotheses about exogenous variables make it possible to simulate the effects of the three scenarios on the GDP and public accounts. In this exercise, exports are assumed to progress at steady international prices, which itself is a debatable hypothesis. The last column of table 3 shows a possibility that supposes $80 as the average price for a barrel of oil in 2014–2015. Net losses on exports then reach $65–85 billion according to this scenario. The consequences of this would be additional pressure on the rouble’s exchange rate and on the stability of the financial sector.
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Table 3. Macro-economic consequences of the three scenarios and low variant for oil prices: 2015

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Change in investment</th>
<th>Fiscal balance (% GDP)</th>
<th>Change in GDP</th>
<th>Effect on exports with one barrel of oil costing $80</th>
</tr>
</thead>
<tbody>
<tr>
<td>De-escalation</td>
<td>+2%</td>
<td>-2%</td>
<td>+3%</td>
<td>-$80 billion</td>
</tr>
<tr>
<td>Stalemate</td>
<td>0%</td>
<td>-5.5%</td>
<td>+1%</td>
<td>-$75 billion</td>
</tr>
<tr>
<td>Conflict</td>
<td>-6%</td>
<td>-14.5%</td>
<td>-3%</td>
<td>-$65 billion</td>
</tr>
</tbody>
</table>

Source: author’s calculations.
Conclusion

1. A comparison of the consensus of the estimates of late 2013 and current prospects shows that the Ukrainian conflict cost Russia more than 3% of its GDP during the first ten months of 2014—that is, more than $60 billion. This is supplemented by losses (in part virtual) recorded on the Moscow stock exchange ($30 billion compared to January 2014) and the loss of international purchasing power related to the rouble’s depreciation (-20% at the end of October, i.e., the equivalent of $400 billion).

2. The sanctions did not begin to have a real impact on the Russian economy until the summer, by increasing capital outflow and then cutting off key companies in the Russian economy from their usual funding channels. The counter-measures Russia adopted regarding food imports have increased the inflationary trends sparked by the rouble’s depreciation. It should be noted that the impact of these events on the European Union’s situation is also significant, but on a scale ten times lower in proportion to its economy. However, it is not distributed equally between Russia’s trading partners (Ministry of Finance of Finland, 2014).

3. The scenarios studied for 2015 bring out a strong sensitivity of the macro-economic developments to the situation in the Donbass, through the mechanism of the sanctions and counter-sanctions that has already been set in motion, but especially through the greater uncertainty that weighs on global demand. Between the scenario of exiting the crisis and that of a new conflict, the gap is 6 GDP points for 2015. If the recent change in hydrocarbon prices is borne out and continues throughout 2015, the negative impact on growth could increase by a few additional points and call into question the external sustainability of Russia’s economic trajectory.

4. This study does not consider the structural impact of events that have occurred in Ukraine since early 2014. In terms of access to financial markets, technological development¹⁵, modernisation of productive capacities, change in the institutional environment and potential growth, the consequences of the current tense climate are far from trifling. However, if Russia’s relations with the Western countries improved, the prospects for growth would become more

¹⁵ According to a research note by Merrill Lynch, the sanctions on the exploration of off-shore deposits in the Arctic could represent up to $800 billion of lost income in terms of multiplier effect losses (Reuters 14/08/2014).
favourable and trade could resume quickly, including in the areas of investments and technology transfer.

5. For the time being, the government has sizable levers to fight the effects of the sanctions and counter-measures on the Russian economy: the Central Bank’s foreign-exchange reserves are still substantial, part of the contingency fund could still be used to support the most-affected sectors, and the government is still not in great debt. These advantages could enable the government to temporarily offset the consequences of the gradual isolation the national economy is undergoing. But considering the structural features of the Russian economy, whatever form they take, counter-cyclical policies will have a lasting effect on Russia’s growth only if they are supported by a stable resumption of business relations with the West.

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The Russian economy is on the razor’s edge. Its structural needs in terms of modernisation are substantial: in the medium term, considering the weak demographic dynamics, high employment level and investment deficit over the last twenty-five years, returning to a potential annual growth rate of 5%–7% could be achieved only through a fast replenishment of capital stock and a lifting of the qualification level of labourers, who generate productivity gains. This prospect would also represent a relay of potentially considerable growth for the Western companies that could be involved in it. Of course, in the coming years the Russian economy could end up on the path of a quick and sustainable medium-term growth, with its regional weight causing domino effects on neighbouring countries. But for this prospect to become a reality, the Ukrainian conflict needs to be resolved in a peaceful and lasting manner.

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References


