The Impact of Sanctions on Russia **Rt. Hon Sir Roderic Lyne KBE CMG**

Recent visitors to Moscow and other Russian cities see few visible effects of war. Life on the surface appears normal. Russia started with $640 billion in the reserves. The rouble has risen. A widely-quoted Bloomberg analysis, using official Russian statistics only for March, estimated that the spike in prices would give Russia oil and gas revenues a fifth higher in 2022 than in 2021.The Financial Times (Leader, 20 August) speculates that “Putin may calculate Russia is better placed to withstand the economic pain than many of its western counterparts”. After six months and successive rounds of G7, US and EU sanctions, Russia is not cracking. How will it be a year hence?

Closer analysis suggests that even Russia’s famous resilience will be sorely tested.

The Russian economy did not enter the crisis in good shape. It is in its third recession since 2008 – a period of stagnation in which average living standards have declined with a corresponding rise in popular discontent. Russia is paying the price for the Putin administration’s failure to invest, to modernise and to diversify; for nationalisation and Kremlin control at the expense of entrepreneurship; for massive corruption and inefficiency; and for dependence on hydrocarbon exports and the import of foreign (mainly Western) technology and services. This has left Russia acutely vulnerable to sanctions – much more so than the autarkic Soviet Union.

To ward off an economic collapse the Russian Government and Central Bank has had to use extreme measures. Stringent exchange controls were introduced to stabilise the rouble, which lost three quarters of its value in a fortnight after the invasion. By late August it had risen 25% above its pre-invasion rate, boosted by high oil prices. This is not an unqualified benefit for a country scarred by Dutch disease. Sanctions of unexpected severity prompted the Government to respond with a massive fiscal and monetary stimulus, a spending spree of loans and subsidies targeted at both companies and individuals. Money supply has ballooned. The headline inflation rate has reached 20% - its highest point since the 1990s – and in some sectors is over twice that level. The National Wealth Fund has been raided. Half of the foreign reserves are frozen under sanctions and another $75 billion has been spent since February. When the costs of war are added in, this level of spending is unsustainable. With the international debt markets closed after Russia’s default, the deficit must be funded internally.

The Russian budget is notoriously dependent on hydrocarbons (accounting for around 60% of Government revenue). These revenues dropped, on a monthly basis, by over 50% in May. The Bloomberg projection has been contested in a detailed study by Yale University[1]. As the Yale study points out, the reduction of gas supplies to Europe (83% of Russia’s export market) will hit revenues severely. Russia has only one pipeline to China (not connecting to Western Siberia or the Arctic) and limited LNG capacities. Yale has described this as Russia’s “self-inflicted destruction of its export-oriented gas sector”, to the benefit of LNG exporters from Qatar, the USA and Australia. Oil exports normally bring in three times as much revenue as gas; but the Russians are having to discount oil sales to China and India by up to 30% and revenues will fall further if the oil price continues to soften or the West succeeds in imposing a price cap. Oil production will suffer from the withdrawal of Western technology and investment and is forecast to fall by up to 17% in 2022 – and to continue falling.

[1] “Business Retreats and Sanctions Are Crippling the Russian Economy”, Yale Chief Executive Leadership Institute, August 2022

Other businesses, great and small, are suffering badly. Over a thousand foreign businesses (including Chinese) have left Russia. Chinese exports to Russia have fallen by a half. Large manufacturers and the extractive industries, dependent on foreign parts and proprietary software, have had their supply chains disrupted. Car production has fallen by 75%; consumer durables such as washing machines by about a half; smartphones have become “deficit goods”; the aviation industry is having to cannibalise Boeing and Airbus aircraft. The manufacture of armaments to replace losses in Ukraine is greatly impeded by the unavailability of foreign parts, including microchips. Many medium and smaller businesses are cut off from suppliers or markets because their foreign exchange accounts and credit cards are blocked.

The sanctions with least impact, though popular with public opinion in the West, have been those against individuals. They will not have influenced the small circle of Putin’s close associates; and most of the millionaires and celebrities filling out the lists had little connection and zero influence on him. More damaging to Russia has been the exodus of an estimated 300-500,000 talented young professionals; and the cutting off of research links to the West.

Conclusion

The outlook for Russia in 2023 and beyond is bleak. In the words of one analyst[2], Russia faces “a perfect storm leading to higher inflation, falling consumption, lower investment and lower incomes as the state struggles to avoid or limit budget deficits”. The effects are already clear to the elite and will seep down into an already discontented population in the months ahead. Elements in the Russian Government struggling to manage these burdens must privately be hankering for a way out of a war which most of them would not have started. If Putin remains true to past form, however, he will double down rather than change course. As disaffection surfaces, he will employ ever more repressive measures to retain control; but the failing economy could, by degrees, threaten the regime’s stability by rendering Russia ungovernable.

Sir Roderic Lyne

Sir Roderic Lyne was the UK's Ambassador to Russia during President Putin's first term, since when he has consulted, written, lectured and broadcast extensively on Russia.

[2] Nick Trickett, Fitch Solutions, in the Moscow Times, 17 August 2022