How tough are the sanctions on Russia?

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Although Russia is more prepared to withstand sanctions now compared to 2014, the sanctions imposed in response to the full-scale invasion of Ukraine are significantly tougher, which means they will have a much stronger effect on the Russian economy. In addition, hundreds of foreign companies have suspended their activities in Russia, and the population faces a new reality, characterised by high inflation, unemployment and a decreasing living standard.

In response to Russia's war in Ukraine, the West has imposed economic sanctions on Russia. The sanctions target the financial sector and are intended to destabilise the Russian economy. Some banks have been banned from the Society for Worldwide Interbank Financial Telecommunication (SWIFT) system and assets in foreign banks are frozen. Russian citizens immediately tried to save their deposits, withdrawing cash from the banks and converting roubles into USD and EUR. On 8 March, the Central Bank of Russia (CBR) ceased exchanging roubles for foreign currency, which means the rouble is no longer convertible. Russia has also forbidden transactions entailing the transfer of foreign exchange to accounts abroad. These measures are meant to stop the outflow of foreign currency, but also further isolates the Russian economy.

The toughest measure imposed so far by the West has been the freezing of CBR's foreign assets in accounts abroad. This has decreased Russia's war chest and harms the CBR's ability to support the economy and the rouble. The normally strong correlation between the rouble exchange rate and oil prices has broken down and the currency has weakened sharply against the USD. On 23 February, the day before the invasion, the rouble began to decline from 80 RUB/USD and was around 130 RUB/USD two weeks later, but has since recovered slightly. The CBR increased the key rate to 20 from 9.5 per cent, which is meant to further stem the outflow of foreign currency.

EU has expelled seven banks from SWIFT, e.g. Bank Otkritie, Promsvyazbank, Bank Rossiya, Vnesheconombank (VEB) and VTB Bank. This means that these banks cannot handle international transactions. There may be problems inside Russia as well, although the System for Transfer of Financial Messages (SPFS) should enable transactions within Russia. EU imposed a ban on issuing bonds, shares, and loans within EU for refinancing Alfa Bank and Bank Otkritie, after having earlier frozen assets of Bank Rossiya, Promsvyazbank and VEB. EU has put a cap of EUR 100,000 on the EU bank accounts of Russian citizens, who will not be allowed to buy EUR-denominated shares.

Additionally, five Russian banks have been sanctioned by the UK. The assets of these banks are now frozen, and they are denied from raising funds in Britain. These banks are cut off from sterling markets and clearing payments. The US has targeted Sberbank and VTB, the two largest banks in Russia, along with three other banks, and put them on the Specially Designated Nationals (SDN) list. The US sanctions also target two Belorussian state-owned banks, Belinvestbank and Bank Dabrabyt. Together, the Western sanctions target about 70 per cent of the Russian banking market.

Turmoil in Russian financial markets

The sanctions have roiled Russian financial markets. The stock market dropped significantly following the Russian invasion on 24 February and was still closed for trading in mid-March. Banks are under pressure from increasing cash withdrawals and pressure could mount further if borrowers are unable to repay loans. As mentioned earlier, the CBR and the government have tried to mitigate financial turbulence and protect the rouble. Companies have been ordered to sell foreign currency to the CBR to support the rouble. The success of these various measures is unclear, however. There is no doubt that the sanctions have contributed significantly to creating chaos in Russian financial markets.

Rating agencies have downgraded Russia's credit rating to junk status, implying that there is a substantial risk that Russia will default on its foreign debt. The IMF does not regard a Russian default as an improbable event. One of the main reasons why a country with large foreign reserves could default is the freezing of CBR's foreign reserves.

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Russia has the money to service debt but cannot access it. According to the Russian minister of finance, Anton Siluanov, foreign sanctions have frozen around USD 300 billion of the USD 640 billion that Russia has in its foreign reserves. Starting on 16 March, Russia was scheduled to make a combined payment of USD 117 million in interest payments on two dollar-denominated bonds. Although Russia has a 30-day grace period to make the payments, this is probably just the start of a series of payments that will signify challenges for Moscow. The cost of insuring Russia's debt against default has surged since the start of the war in Ukraine, as traders have been anticipating that these insurance contracts could be triggered if payments are made in roubles or not at all. Credit rating agencies would likely consider Russia to be in default if Moscow misses payments or repays debt issued in USD or EUR with other currencies, such as the rouble or China's RMB. A default risks driving the few remaining investors out of the country and further isolate the crumbling economy.

Russia last defaulted on its domestic debt when the country was plunged into a financial crisis triggered by a collapse in commodity prices, in 1998. Its most recent foreign currency default came in 1918, when the Bolsheviks repudiated bonds issued by the Tsarist government.

After sanctions were introduced in connection with the illegal annexation of Crimea, in 2014, Russia has worked determinedly to diminish the economy's vulnerability to sanctions. Efforts include a build-up of the CBR's reserves, decreased dependence on trade with the West, and ensuring stable government finances as well as a reduced dependence on foreign currency and foreign investors. In 2022, the Russian economy is also buttressed by high energy prices. On 23 February, the price of oil (Brent crude) was close to 97 USD but rose to 125 USD during the following two weeks.

However, despite these supporting factors, the sanctions have put the Russian economy under heavy pressure and nullified some of the efforts to sanction-proof the economy. The fact that the CBR has lost access to roughly 50 per cent of its reserve assets is a serious setback. Furthermore, although Russia has engaged in import substitution and diverted some of its imports from the West to Asia, the import dependence on the EU is still substantial. The sharp fall in the value of the rouble means that the prices of imported goods will rise significantly.

Impact on the Russian economy in the near/medium term

Although it will be some time before the impact on the real economy can be observed in economic data, it is possible to predict roughly what will happen going forward. The sharp CBR interest rate hike will harm both private consumption as well as corporate investment. The weakening of the rouble will push inflation even higher. Some observers predict that the rouble will continue to plummet, approaching the rate of 200 per USD by the end of the year. According to Russian economists, the annual inflation rate could reach as high as 20 per cent. Already back in February 2022, the inflation rate was 9.2 per cent, twice the inflation goal of the CBR. Most estimates of the Russian GDP contraction for 2022 range between 5 and 10 per cent.

In addition to the immediate impact through financial markets, sanctions are already starting to have profound effects on real economic activity. A large number of foreign-owned corporates, of various sizes, including energy giants such as BP, Shell and Exxon; and consumer brands such as IKEA, H&M and McDonalds, have communicated that they are suspending their business operations in Russia. This includes both production, sales and investment. Joint ventures between foreign and Russian businesses are being cancelled. This severely hurts the Russian economy, which loses direct investment and access to advanced technology, contemporary management methods and jobs.

Although Russia was more prepared to withstand sanctions now than compared to 2014, the fact that the sanctions are significantly tougher means they will have a much stronger effect on the economy. What could make things worse is if EU imposes energy sanctions. So far, the EU has declared that it will decrease its import of gas by two-thirds until the end of 2022. The US has sanctioned import of all Russian gas and oil, but the US share of Russian gas and oil exports is much smaller compared to that of the EU. Export restrictions on advanced technology have also been strengthened, which deprives Russia of technology transfer. This could cause long term harm to the Russian economy. All in all, sanctions have and will continue to have a negative impact on Russia and contribute to the decline of an already stagnant living standard. ■

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