The sanctions against Russia

Were the Russia sanctions a mistake?

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August / September 2022

At first glance, the results of the Russia sanctions are sobering. There is no sign of even a rudimentary relenting in the war against Ukraine. The energy price shock, on the other hand, has had a severe impact on the economies of Europe. Were the sanctions a mistake?

About seven months ago, the EU, the USA and many other industrialized countries began imposing a wide range of sanctions on Russia. It is already clear that the measures have not achieved some of the hopes that were placed in them. While the sanctions will cause significant long-term damage to the Russian economy, in the short term they have hardly weakened Russia, which is expected to have record energy revenues and a huge foreign trade surplus in 2022.

Sanctions have a long-term effect

Most economists were already in broad agreement that the effects of sanctions generally take a few years before the desired impact is achieved. Russia's economy - to the extent that sanctions are maintained - will suffer considerable damage in the long term and be set back in its development. Western companies have largely withdrawn from the country. The fact that technology imports from Western countries are prohibited is arguably already hampering production in the aviation or automotive sectors, for example. In addition, Russian financial institutions, including the central bank, have been cut off from international payments, so that Russian companies have often lost access to developed markets.

In the long term, it will be a considerable disadvantage for Russian energy companies, as Western customers are gradually becoming less dependent on imports from Russia. Hopes that the loss of established sales markets could easily be compensated for by more intensive trade relations with China, India and other emerging markets are likely to be met with disappointment. These countries will demand concessions, and they have nowhere near the payment power of the OECD countries.

Russia achieves record surpluses in the short term

In the short term, however, the picture is quite different. Russia's GDP is likely to decline significantly in 2022 and 2023, but the sanctions have not made it very difficult to finance the war, nor have they had any discernible impact on political decisions. Since the energy sector was not fully affected by the sanctions, Russia's export revenues have risen sharply and are heading for record levels in 2022.

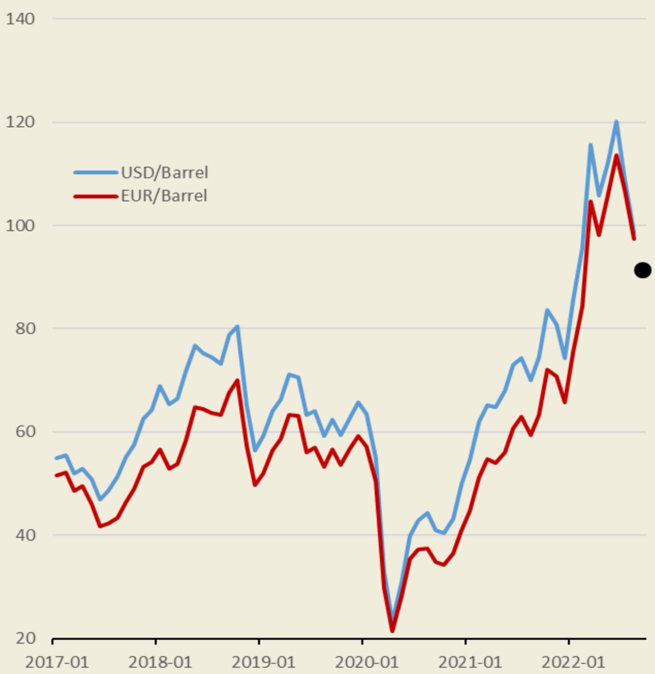
Although Russia is exporting less oil, coal, and gas to the Western world in terms of volume, the price increase for these energy sources is far outweighing this decline. The price increase was also exacerbated by the fact that sanctions and possible energy embargoes against Russia were discussed for months at the international level, but actual import volumes fell only moderately.

Publication date: 23/09/2022 09:00

And what Russia could not sell to the West flowed to Asia and other emerging markets close to Russia. Thus, according to statements by the central bank, Russian export revenues have risen much stronger than expected.

Fig.1 Severe distortions of the oil market in Europe

Crude oil price (Brent, spot) *



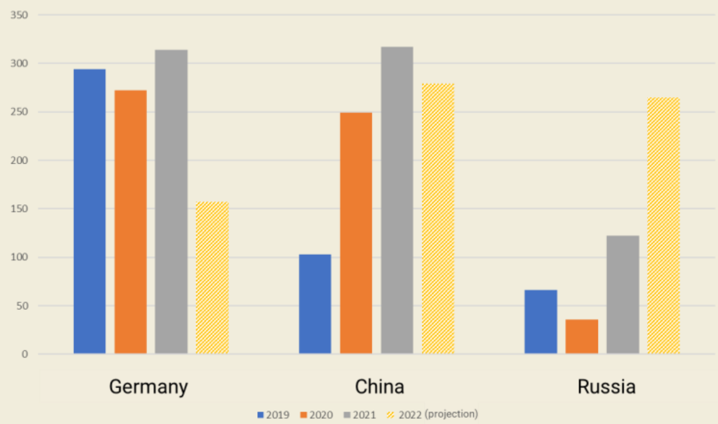
* point marks average from 01.09-12.09.2022

Source: World Bank, ECB, EEX, US Energy Information Administration, own calculations

Together with declining imports, this is likely to push Russia's current account surplus to a record USD 250 - 300 billion this year. Russia's export surplus would thus be about as large as China's and twice as high as the surplus of former world export champion Germany. Even if Russia's significantly increasing foreign exchange reserves can no longer be used freely due to the financial sanctions, there can be no question of the country having financing problems.

Fig. 2 Russia's huge export surplus

Current account balances in USD billion



Source: IWF External Sector Report 2022; own projection for Germany 2022, Destatis

Possible consequences of price caps for Russian gas & oil

Currently, there are international discussions about price caps for Russian oil and gas in order to cap Russia's earnings and the upward pressure on prices in consumer countries.

In fact, such instruments could result in an even more extensive supply freeze by Russia, as Putin has made it clear that Russia will not abide by contracts if such sanctions are taken and will not supply oil and gas to companies that demand a price cap.

The gas market is of particular importance here. It is true that the EU was able to reduce imports of Russian gas to a share of slightly less than 10% during the summer months. Germany now receives only small amounts of gas from Russia and has replenished its storage facilities.

This is a success, although it cannot be a reason to give the all-clear. Demand for gas will rise very sharply in the winter months and substantial savings or even rationing will then be necessary if, as is to be expected, supplies from Russia fail to materialize.

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Many European countries are still dependent on Russian energy

Moreover, there are many countries in Europe that are still heavily dependent on Russian energy. Despite conservation activities and new suppliers, they are already on the brink of recession due to energy price increases. These include Eastern European economies such as Bulgaria, Hungary and the Czech Republic, but also Finland and Austria. An abrupt supply freeze for all EU countries would significantly exacerbate the energy crisis through price increases for gas and electricity.

Price caps or import embargoes on energy from Russia are unlikely to trigger changes in Russia's war policy. The loss of foreign exchange income would be bearable for Russia for some time given its large foreign exchange cushions, which in any case do not play the decisive role in financing the war.

However, the long-term weakening of the Russian economy through permanently low energy exports to the markets of OECD countries would be serious. Given the recent escalation of the conflict and Russia's partial mobilization, however, one may doubt that these long-term effects play a role in Putin's political calculations. Possibly, there is confidence that energy supplies to friendly states such as China and India could be increased accordingly in the long term.

The alliances of autocrats

The redirection of trade and capital flows is already in full swing. China has massively expanded its exports to Russia over the years and, even before the war, has become Russia's largest supplier by far; a position held by Germany twenty years ago. Alliances between Russia and China, as well as those with other autocratic states, are becoming much stronger, even if the recent escalation in the Ukraine war is politically displeasing in China, for example.

The prospect of cheap energy and other commodity imports from Russia is extremely positive for many emerging economies, promising higher prosperity and new competitive advantages over developed economies.

If developments continue as they have this year, trade flows and capital flows will intensify between, for example, Russia, China and allied countries that are politically and economically close to them. And at the same time, the democratic countries of the West, together with developed economies of Asia, will intensify trade and capital flows among themselves. Globalization will not end, but it will change its pattern.

From the point of view of the democratic community of countries, the formation of a bloc is not a good development, neither politically nor economically. The advantages of the global exchange of goods will be used to a lesser extent and the already manageable cooperation on important global political issues such as climate policy or development policy will be further diminished. To counter this, dialogue and the further development of the international regulatory framework are needed. Economic sanctions, which could increasingly be directed against China, should not be relied upon; they are more likely to exacerbate nationalistic tendencies in politics.

Quick solutions are not in sight

It is likely that the fighting in Ukraine will continue for some time. Sanctions are unlikely to change the situation in the short term, rather it would come from military failures by the Russian army. With no ceasefire or political negotiations in sight, European countries in particular must prepare for a prolonged period of strains and energy shortages. However, the willingness of the population to accept harsh restrictions due to sanctions and counter-reactions will be put to the test.

Sanctions that do not decisively weaken the addressee or induce it to make political concessions, but at the same time hit the initiator hard economically, will become increasingly difficult to negotiate. In terms of economic policy, this will mean that even more relief packages for private households and the companies affected are likely to be adopted. This will lead to increasing public debt and thus to very long-term effects of the Ukraine crisis.

An easing of sanctions is currently not politically on the table, as no negotiation offers have been made by Moscow. The long-term damage to the Russian economy does not seem to trigger a willingness to change course, and in the short term, the economic pressure is bearable for Russia.

The crisis will have to be resolved through military and political processes, not sanctions. If this does not succeed in the near future, Russia, with its vast wealth of raw materials, will increasingly become an ally of China and other autocratic states. As a result, China will gain power. This insight is also likely to be present in U.S. policy, whose focus is primarily on Asia. This could increase the pressure to bring about a political solution to the Ukraine war and thus also to resume economic relations with Russia. However, the prospect of this is still some way off.

Publication date: 23/09/2022 09:00

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Conclusions for the capital markets

Uncertainty about the Ukraine conflict and the supply situation as well as price developments on the energy and commodity markets will persist for an undetermined period.

However, this and the expectation of a recessionary trend, especially in the European economies, should already be largely reflected in stock market valuations, which have recently fallen considerably.

Russia's threat potential has diminished considerably with the declining market shares in the energy supply of Western countries. In this respect, even a continuation of the conflict should not stand in the way of a later recovery of prices. Crucial to this is the prospect of a decline in the currently very high inflation rates and thus the expectation of a less restrictive monetary policy.

These developments are not completely independent of developments in Ukraine, but are much more dependent on global economic developments and the orientation of the most important central banks.

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