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RUSSIA'S ECONOMY IS BETTER THAN EXPECTED, BUT NOT OUT OF THE WOODS

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This issue of how effective sanctions are in dealing with recalcitrant nations is being discussed once again amid reports that Russia's economy is faring better than expected two years after the U.S. and European Union imposed sweeping sanctions on it.

RUSSIA'S ECONOMY

Sanctions have included freezing Russia's holdings of foreign exchange and gold reserves, limiting the central bank's ability to use dollars and euros, and capping prices for Russian oil exports and products. In 2022 Russia garnered the distinction of being the most sanctioned country, with over 13,000 restrictions—more than Iran, Cuba, and North Korea combined, according to the Carnegie Endowment for International Peace.

IMPACT OF SANCTIONS IS A MIXED BAG

The initial assessment of many observers was that the Russian economy would be hit very hard. The most visible indication was a steep plunge in the ruble from March to June 2022. The ruble rallied in the second half of the year, and it weakened again in early 2023 as the European Union imposed a price cap on Russian oil exports.

Russia's real GDP declined by 2 percent in 2022, and Western analysts anticipated a further contraction in 2023. Instead, the economy grew by more than 3 percent, exceeding most Western economies. Moreover, the International Monetary Fund's forecast for this year was recently revised up to 2.6 percent from 1.5 percent.

A common explanation for Russia's favorable performance is that it has circumvented much of the impact of sanctions.

Anne Krueger, former first deputy managing director of the IMF, contends that the sanctions gave rise to several intermediaries that effectively became "laundromats" for Russian oil and other goods. Also, while oil traders were forced to secure tankers with suitable insurance coverage, oil prices did not fall below $60 per barrel, and it has been well above that level much of the time.

Krueger's assessment is the effectiveness of sanctions tends to wane over time, while the burden on the countries enforcing them increases. One potential cost is that the dollar's prominence in international finance could wane over time, called "de-dollarization."

Work coauthored by Jeffrey Sonnenfeld and Steven Tian of Yale University counters that the sanctions were more effective than many perceived. They enumerate several ways in which they have hurt Russia's economic potential, including a brain drain from an exodus of human talent, large capital flight, the loss of Western technology and know-how, the withdrawal of foreign direct investment, the loss of the ruble as a convertible currency, limited access to global capital markets, and a loss of financial wealth. In their view, the combined impact lowers Russia's long-term growth potential.

POLICIES SHAPE RUSSIA'S RESILIENCE

Another explanation for Russia's resilience is that Vladimir Putin's policies have put the country on a wartime footing. The 2023 defense spending budget doubled to more than $100 billion, representing one-third of all public expenditures. The Russian finance ministry estimates that the war-related fiscal stimulus in the past two years was equivalent to about 10 percent of GDP.

Some of Russia's top economic officials have expressed concern that the surge in public spending could cause the economy to overheat and inflation to accelerate from the current pace of 7 percent. Previously, technocrats from the finance ministry and central bank helped steer the economy through financial crises by targeting inflation, building foreign exchange reserves and reining in additional spending.

Putin's assessment is more upbeat. In a recent speech in Tula, the center of Russia's arms industry, he crowed that Russia's economy is now bigger than all but two Western countries, according to the World Bank's GDP rankings by purchasing power parity. Putin believes he has the advantage if the conflict is protracted because it is harder for Western democracies to stay committed.

ECONOMIC INSTABILITY CONTINUES

Russia's economy, however, is not as strong as some observers perceive. Reportedly, the number of corporate bankruptcies in the first two months of this year increased by 57 percent over a year ago, as a two-year moratorium on bankruptcies was lifted while firms confronted rising interest costs.

Nor should one forget that sanctions were imposed because Russia's invasion of Ukraine was one of the boldest attacks on another sovereign nation since the end of WWII. As such, the U.S. and Western alliance needed to send a strong message about the consequences Russia would face. Namely, if a country does not abide by the rules of the international order, it is not entitled to the benefits.

I subscribe to former Senator John McCain's (R-Ariz.) observation about Russia in early 2015 after it seized Crimea. In a CNN interview, he called Russia "a gas station masquerading as a country."

"It's a nation that's really dependent upon oil and gas for their economy, and so, economic sanctions are important," he continued.

Meanwhile, Elina Ribakova of the Peterson Institute for International Economics has updated McCain's assessment, saying, "The Russian economy now is like a gas station that has started producing tanks."

As such, Russia is highly vulnerable if energy prices decline or increased production of military hardware leads to diminished output in other parts of the economy.

Vladimir Putin is well aware of this and reportedly will likely raise taxes on companies and high-income earners after the country's recent elections. Accordingly, the whole story about Russia's resilience has yet to be told.

A version of this article was posted to TheHill.com on March 17, 2024.

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