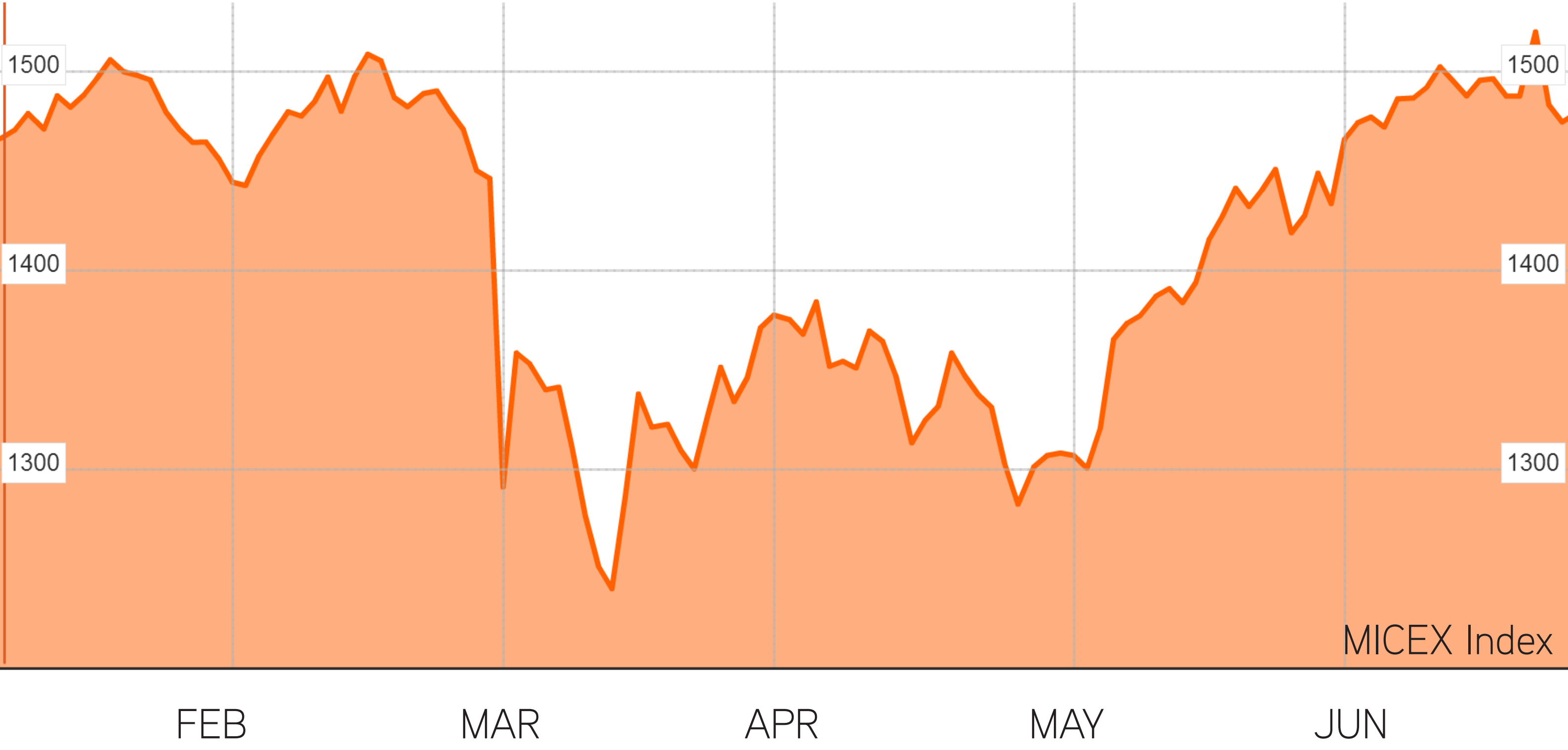

European Leadership Network

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Policy brief

The Effects of the Ukraine Crisis on the Russian Economy

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If the Ukraine crisis has undoubtedly altered Russia's position in the global order, it is less clear what effect the crisis might have upon domestic economic and political development. It is in this area, however, that the crisis may exert a longer lasting influence over Russia's future. This is not because Western sanctions are causing any obvious deterioration in Russia's economic performance. Although it is difficult to identify precisely what effect sanctions have had or will have on Russia's economic performance, the effects are likely to be modest.

Instead, the argument made here is that the Ukraine crisis and the application of sanctions by the US and its allies against Russia may prove to be of profound importance in the long run because of the effect that they will have upon the trajectory of political economy in Russia. Quite simply, by strengthening statist and conservative factions within Russia's policy elite, sanctions are likely to weaken the more liberal and reformist factions within Russia. In the long run, this may well cause Russia to turn away from its post-Cold War reintegration with the global economy and instead adopt an increasingly statist and autarkic model of political economy. As one of the world's largest economies, as well one of the largest exporters of energy, this would be an extremely unfortunate outcome.

The economic effects of the crisis and Western sanctions

The Russian economy was slowing down a long time before the outbreak of the crisis in Ukraine. GDP growth slowed to just 1.3 per cent in 2013, down from around 4 per cent in in 2012, and considerably lower than the 1999-2007 average of over 7 per cent. Total investment fell slightly in 2013 as major investment projects associated with the Sochi Olympics, as well as some major energy infrastructure projects, were completed. Private investment, which has been a perennial problem in Russia, remained low. Capital outflows intensified in early 2014, reaching a total of over $50bn in the first quarter. This was accompanied by the steady depreciation of the rouble that began in the summer of 2013 as the Central Bank adopted a more relaxed attitude to exchange rate fluctuations.

Thus, even before Russia's annexation of Crimea and the subsequent application of economic sanctions against Russia, there were clear signs that the growth model that had served the Russian economy so well since 1999 was running out of steam. While some of this turnaround in fortunes can be explained by readily identifiable factors, such as a shrinking labour force, the end of rapid oil price growth, and a stagnant European economy, it is also true that something else is holding back private investment in Russia. Quite what this something is remains a matter of debate. Possible solutions range from reducing corruption and strengthening property rights to increasing competition and broadening access to finance. What is clear, however, is that economic reform of some nature is required to boost private investment and thereby the prospects for rapid and sustained economic growth in Russia.

The Ukraine crisis and the associated sanctions exacerbated this downward trend. In March and April, the depreciation of the rouble that was already well underway accelerated sharply as capital outflows continued. But by May there were signs that normality was being restored. Capital outflows slowed and the rouble returned to pre-crisis levels. The two main Russian stock exchanges, the RTS and MICEX, both recovered most of their losses. The federal budget even benefitted from the depreciation of the rouble as its largely dollar-denominated income (from energy exports) increased relative to its ruble-denominated expenditure. As a result, a small federal budget surplus is forecast for 2014. Other indicators suggest that Russia may avoid even a short technical recession that looked likely at the height of the crisis in April.

Of course, sanctions were not intended to have an immediate economic impact or cause a recession in Russia. As policy makers like to say, sanctions are what you do when you don't know what to do. Instead sanctions were intended to signal Western displeasure with Russia for its role in the Ukraine crisis, and are aimed primarily at inflicting economic pain upon the 'Inner Circle' of individuals considered to be close to the Russian President, Vladimir Putin. As well as targeting the 'Inner Circle', the US also applied restrictive measures on technologies or services associated with defence products.

Broader, sector-wide sanctions have also been floated as a possible reaction to any further perceived escalation by Russia in Ukraine. Such sanctions may affect investment in Russia's crucial energy industry, and would have the potential to significantly harm specific projects in Russia that are dependent on foreign technology and expertise, such as ventures aimed at exploiting deep-water reserves.

However, while an intensification of sanctions might cause some short-term disruption in Russia, we should not overestimate their probable macroeconomic consequences. As far as the global economy is concerned, Russia's role is primarily that of energy exporter. Consequently, only policies that cause a reduction in demand for oil, gas or coal are likely to have a significant impact on Russia's economic performance. Thus far, no such reduction in demand has occurred. If anything, heightened geopolitical tensions in Iraq and the wider Middle East, as well as Ukraine, have all caused oil prices to rise, something that has benefitted energy exporters like Russia.

Russia's role as one of the world's most important oil and gas exporters also make it difficult for external powers to threaten, in any credible way, to expand sanctions any further to include, for example, an embargo on Russian hydrocarbon exports. Reducing global supply of oil or gas by placing an embargo on Russian exports would, apart from being very difficult to enforce, inflict serious damage on energy consumers across the world, as prices would rise sharply.

It is more likely that Western governments would stop short of an embargo and instead opt to make it difficult for energy companies, such as Exxon-Mobil or BP, to do business in Russia. But if Western governments choose to do so they will encounter stiff resistance from the companies themselves. Russia, despite its notoriously poor business environment, remains a lucrative place to do business, especially in the energy industry. The tantalizing prospect of exploiting the vast tight oil deposits in the giant Bazhenov formation, for example, appeals to some of the world's largest energy companies, with few alternatives of a similar magnitude on offer elsewhere in the world. Even if restrictions to Western companies operating in Russia were to be implemented, it would only leave other companies unencumbered by sanctions, such as Chinese firms, to take their place.

To sum up so far, the economic effects of sanctions, to the extent that they are clearly identifiable, have been limited. Indeed, it is likely that the macroeconomic consequences of sanctions will remain negligible even in the event of an enhanced package of sanctions being applied to target key sectors of the Russian economy. However, that the macroeconomic effects of sanctions are likely to remain limited should not be seen as comforting for Russian policy makers. The economic slowdown that started well before tensions increased in Ukraine suggests that structural economic reform to improve the functioning of the Russian economy should be a priority for policy makers. Unfortunately, the likelihood of such economic reform taking place in the near future has been much reduced as a direct result of the crisis.

The implications for Russian political economy

If the macroeconomic effects of the crisis and Western sanctions are modest, the impact on domestic political economy is not. Ever since Vladimir Putin announced his return as President in late 2011, economic policy in Russia has taken an increasingly statist turn. Two trends could be observed before the Ukraine crisis.

First is a growing preference for state control over freedom of the market in 'strategic' areas of the economy. This preference goes back to the beginning of the 2000s, but has grown stronger in recent years as Putin has emphasized state-driven economic modernization over a trust in the market. As well as increasing state control over the energy industry, Putin has committed enormous sums to increasing defence spending, large infrastructure projects, and a revival of plans to develop Russia's Far East. This will come at the expense of health and education spending.

Second is a growing tendency towards self-reliance. Although not quite the autarky of the Soviet era, this tendency tends to eschew open interaction with the global economy where possible in favour of either domestic production (i.e., moving from importing goods and services towards domestic production) or managed relations with global companies (e.g., joint ventures between large, state-controlled Russian firms and global companies).

The Ukraine crisis and the imposition of Western sanctions threaten to further reinforce these two tendencies. The liberal policy elite – hitherto well entrenched in Russia's key economic policy positions in the Ministry of Finance and Ministry of Economic Development, as well as the Central Bank of Russia – is likely to be marginalized as economic policies that are consistent with a more statist and xenophobic government take hold. Factions in favour of even greater military spending will become emboldened, and the prospects for future liberal economic reform will be much diminished.

Already, the influential figures, such as Sergei Glazyev (economic adviser to Putin) and Dmitri Rogozin (Deputy PM overseeing the defence industry), have called for increased state investment to boost domestic production in strategic industries, the imposition of greater control over the financial system, and a general shift away from two decades of integration with the largely Western-led global economic system. The longer Russia feels isolated from the global economy, as will happen the longer sanctions persist, the more likely these conservative forces will grow to dominate economic policy making in Russia.

Politically, sanctions also help Putin. Russia looked to be heading towards recession before the Ukraine crisis began. The current system of political economy may well have come under increasing pressure from critics. However, Putin can now shift the blame for any economic downturn onto external forces. While well informed academics and policy makers might think otherwise, the vast majority of voters will likely agree with the President.

Conclusion

The Ukraine crisis and the imposition of sanctions on Russia threaten to change the trajectory of political and economic development in Russia for the worse. This is not because of any painful macroeconomic effects. These effects are likely to be modest. Instead, by boosting factions within Russia's policy elite who favour increased state control and a move away from Russia's integration with the global economy, sanctions threaten to reduce the prospects for much-needed economic reform. While sanctions were no doubt intended as a signal to Russia of Western anger at its actions in Ukraine, it is not clear that they were intended to strengthen statist factions within Russia. However, this may prove to be an unintended outcome. If so, it just goes to show how doing something for the sake of action can prove worse than doing nothing at all.

About the Author

After completing his doctorate at the Centre for Russian and East European Studies in 2009, Richard was appointed CEELBAS Postdoctoral Research Fellow until 2011, carrying out research on knowledge-based economic development in Russia and the wider post-socialist region. He was appointed Lecturer in Political Economy in October 2011. He is also Visiting Professor on the Master of Global Public Policy program at the Russian Presidential Academy of National Economy and Public Administration.

Dr. Connolly's research and teaching on the political economy of Russia focuses on industrial development and structural transformation, economic policy, trade and investment, and Russia's role in the wider global economy. He is currently working on a book exploring the relationship between Russia's role in the global economy and its system of domestic political economy.

Richard is a member of the Editorial Board for Eurasian Geography and Economics, and for the Routledge Series on Russian and East European Studies.

Richard has presented his research to a wide range of academic and non-academic audiences, including the Foreign and Commonwealth Office (FCO), the International Trade Committee of the European Parliament, the Organisation for Economic Cooperation and Development (OECD), the European Bank for Reconstruction and Development (EBRD), the Moscow State Institute for International Relations (MGIMO), the Russo-British Chamber of Commerce (RBCC), and the Royal Institute for International Affairs (Chatham House). He has also provided analysis on Russian affairs for various television and radio channels, including the BBC and CNBC.

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