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The Russian Economic Conundrum

A New Global Stress Test and Reboot of Globalization

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Russia's unjustified assault on Ukraine on February 24, 2022, drove a final stake into the heart of the post-Cold War period, dramatically shifted global politics and economics, and marked a new era of sustained confrontation between Moscow and the West. This unprecedented geopolitical storm could lead in several different directions and impact the future world economic order with staggering consequences. As the process unfolds, it may seem premature to leap to ultimate conclusions. However, the disruptions in international relations and their sizable negative effects on global economic activities have already set off alarm bells. Among them: economic interdependence and threats of severe economic sanctions have not prevented war from breaking out; Russia's impact on energy, metal, and food markets has been misjudged, while the roadmap for energy transition and sustainable development goals has fallen flat and will most likely require substantial adjustments; and Beijing has strongly benefited from Moscow's profound disruption with the West.

In many analyses, there is a wide range of projections, from anticipating anarchical conditions in the global economy to predicting headway on a new set of rules and agreements that could involve deep transformations in the current international financial and economic architecture. Some forecasts even suggest the re-establishment of an old-style *modus vivendi* based on classical principles of systemic Cold War rivalry where the West will find itself locked in a struggle against two major nuclear autocracies, Russian and Chinese. Overviewed here are the significant changes in the global economic environment stemming from the military conflict in Ukraine, particularly in Europe, where outlines of new geopolitical (dis)order are becoming more visible despite the fog of war.

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The Economic Repercussions of the War

February's geopolitical and humanitarian catastrophe has turned out to be a moment of truth, bound by extraordinary unanimity among Western democracies in their solidarity with Kyiv. Moscow's expectations that the whole military intervention would be cheap, quick, and free of collateral damage were evident errors of wishful thinking. Chief among them has been the collapse of the Kremlin's initial blitzkrieg plan for a swift victory. Ukraine, on the other hand, being under existential threat and strongly motivated to defend its sovereignty and territorial integrity, has started an asymmetrical rebalancing of its forces with the help of the West, which has provided weapons and economic assistance to prevent Kyiv's defeat.

From January to July 2022, support from the United States to Ukraine in the form of bilateral financial, humanitarian, and military aid exceeded $54 billion. The second-largest commitment came from the EU, at 15.7 billion euros. However, following the Russian invasion, where thousands of Ukrainians were killed and wounded, with huge destruction of infrastructure, housing, and industrial facilities, the country's economy is expected to contract by 45 percent in 2022; almost half of the businesses there have stopped their operations completely, causing more than 5 million lost jobs. Plummeting tax revenues opened a fiscal gap of at least $5 billion a month, while external financing has only covered around $3 billion a month. Over 6.6 million people have remained displaced within the country, and an additional 6.3 million Ukrainian refugees have scattered across Europe. According to various estimates, total material losses in Ukraine have already ranged between $600 billion to $1 trillion, which is the amount in the form of reparations Kyiv would like to charge Moscow.

The multiple Western sanctions packages introduced since February 2022 have aimed at stopping the war and constraining the capacity of the Russian military-industrial complex. Moscow's consequent use of food and energy resources as war weapons has also turned out to be an integral part of a new reality: the less hybrid and more authoritarian a regime becomes, the less hybrid and more aggressive the war it wages. In one way or another, this new geopolitics has affected various markets and has sharply increased the risks of a global recession. The world economy has already paid a hefty price for the war in Ukraine, dragging down global output by 1.5 percent, raising global inflation by 1.3 percent, tightening overall financial conditions, and taking a toll on production chains.

Sanctions From Hell: A Reality Check

By any measure, the West's punitive terms against Moscow have been unique and extraordinary, aiming to exclude the 11th largest economy from the global system. The most sensitive and unexpected blow has been against the financial sector, where sanctions have blocked almost half of the Central Bank of Russia's (CBR) foreign-exchange reserves (about $300 billion), expelled leading Russian banks from SWIFT, and triggered capital flight from Russia. The latter will likely reach $246 billion for 2022 and is expected to remain at the $125 billion level in 2023. For the first time since 1918, Russia has also marked a historic default on its sovereign debt.

However, the CBR could respond quickly and restore some financial stability, backed by soaring fossil fuel prices. It already imposed capital controls, raised interest rates, and continued strict debt management. It looks like Russian energy exports in 2022 will completely replenish CBR's frozen assets, and the Russian ruble is now being championed by some as the strongest currency in the world. This has created an illusion of normality, but obvious symptoms of Dutch Disease have been bringing a different set of problems, especially for export-oriented sectors. The CBR introduced measures aimed at "de-dollarizing" and "de-euroizing" the economy, forcing banks and businesses to give up using "toxic" currencies.

The use of China's renminbi (RMB; also called the Yuan) has been encouraged by the Russian authorities, with the currency significantly increasing its share in the Russian financial system. It is now in third place by volume of currency trading on the Moscow Exchange. RMB instruments have also become a source of financing for large Russian companies. Still, there are evident weak spots for the Chinese currency, which remains only partially convertible and tightly controlled by the government, with financial assets denominated in RMB still having shallow liquidity.

A second way in which sanctions have struck has been through limits in logistics (the closing of skies and seaports to Russia by many Western countries) and through new trade barriers, particularly restrictions on technological imports. These have led to a widespread disruption of supply chains. Almost 45 percent of Russian imports in machinery came from countries supporting sanctions. These imports will be replaced by less advanced equipment and simple domestic counterparts in the process of "technologically regressive import substitution," as economist Branko Milanovich put it. Ruptured ties with developed economies, including the departure of more than one thousand Western companies from Russia, have fed "reverse industrialization," which looms as a gradual and asynchronous but inevitable degradation across different sectors of the Russian economy. This ongoing crisis has clearly highlighted the geopolitical nature of modern technologies.

The main controversies that have emerged are the self-inflicted measures taken by the West against energy and agricultural exports, which have had shock spillovers on the global economy, particularly through the acceleration of inflation. Paradoxically, many countries that supply weapons to Ukraine are also supporting Moscow's budget by paying for Russian imports of energy, metals, and fertilizers. As sanctions have removed part of a Russian commodity from the world markets, prices have soared, putting sharp upward pressure on energy bills in net importing economies (above all in Europe) and threatening the availability of affordable food in poor countries.

The G7 powers are discussing the establishment of an international price cap on Russian oil to stabilize fuel prices and reduce Moscow's export profits. Another restrictive action may include a ban on the sale of Russian energy resources in dollars and in euros, which could further reduce revenues from oil and natural gas, contributing to almost half of that country's federal budget. In addition, the United States withdrew Russian oil and petroleum products from the national energy market, where their share was about 8 percent. The EU announced the imposition of an embargo on Russian crude, although with certain exemptions and delays in execution by the end of 2022. Russia's oil output will be down 20 percent when the EU ban takes effect early next year. Moscow has been the main EU supplier of oil (29 percent), natural gas (43 percent), and coal (54 percent), but with different dependency rates among member states. Meanwhile, Europeans are stockpiling hydrocarbons from Russia now: delivery of oil products to the European market has increased by 10 percent this summer, while Italy's imports have grown by 20 percent.

At the same time, Moscow has weaponized gas supplies to Europe and significantly reduced gas imports to Germany and other Central European countries, pushing their vulnerable economies toward recession. The Kremlin hopes that a new political cycle in the U.S. and growing economic troubles in Europe will affect the West's domestic and foreign policy priorities, further aggravating political fatigue and undermining the sustainability of sanctions policies. European wholesale gas prices have hit new records, and several EU countries may face physical gas shortages of up to 40 percent of normal consumption this winter.

Many experts believe that European energy dependency is Russia's last economic instrument that can be used in the upcoming cold season. If the EU withstands that pressure, Russia's capacity to break up European unity will radically decrease. Germany has already replaced much of its gas imported from Russia with LNG, sped up renewable energy projects, and as a last resort, could even reconsider a full closure of its nuclear plants. However, Berlin's complete decoupling from Moscow's fossil fuels will take until the end of 2024, and some Eastern European countries have scheduled an end to Russian energy imports only by 2030.

The Russian economy, on the other hand, has already entered a phase of "structural transformation"—a euphemism used by Russia's Central Bank to define a deep structural crisis. According to the CBR's recently refined baseline scenario, the country's GDP will fall by 6 percent this year, with a level of inflation up to 15 percent.

Alternative Safety Net?

Moscow's rupture with the West drives the country to pursue deeper relationships with economies outside the sanctions coalition, trying to create new logistical, financial, and trade corridors to maintain connections with global markets. This group incorporates both rogue states and so-called "global swing states," which have a "fluid approach" to the international order and seek advantage from diverse relationships. The first major corridor involves the Gulf states: Saudi Arabia remains a key Russian partner in the OPEC plus agreements, and the United Arab Emirates has taken over a leadership position as one of the largest Russian financial, business, and travel hubs. A second logistical corridor has been built through Turkey, which has close energy, trade, and tourism ties with Moscow and is now used for growing financial and technological transfers. Teheran, recently visited by President Vladimir Putin, has become another route for shadow trade, illicit financial flows, and delivery of low-quality equipment.

Capitalizing on 30 percent discounts, Delhi has significantly increased purchases of Russian crude, offsetting Moscow's loss of Western markets. As the EU is going to wean itself from Russian refined petroleum production, India could be converted into a refining hub of Russian oil for Europe. But the key component of Russia's pivot from the West to the East has continued to be expanding cooperation with Beijing, based on a "rock-solid" strategic partnership that "knows no limits."

China and Russia have coordinated their efforts to build an alternative international trade, finance, and technology network that could replace the existing economic order. The deterioration of both countries' relations with the United States made it easy for them to sign an agreement on the eve of the Russian invasion of Ukraine, a de-facto pact against the West. Beijing has criticized sanctions against Russia, but to Moscow's great disappointment, Chinese firms and banks with global exposure have been rather cautious in their interaction with Russia. Some even put bilateral financial transactions and trade on hold to avoid secondary risks and sanctions. In any case, a weakened Russia is a gift for China, increasing Moscow's reliance on Beijing and fortifying China's dominant position in this autocratic duet.

Conclusions

The war in Ukraine has marked a tectonic shift in world geopolitics and has become the worst security crisis affecting Europe since World War II. The Russian invasion of Ukraine has impacted all regions of the world, contributing to slower economic growth, faster inflation, supply chain disruptions, fuel and food shortages, and increasing poverty. The military confrontation has also triggered the growth of defense spending and significant new investments in the military-industrial complex.

The benefits of economic interdependence and globalization have been sacrificed in this conflict: financial systems, production chains, and technology transfers have been weaponized and turned into harmful instruments of a proxy war. The recent events have shown that the world is moving toward an updated version of globalization, where international economic cooperation and trade will most likely be ally-oriented with selective deglobalization and isolation of autocratic adversaries.

The controversial short-term outcomes of harsh Western sanctions on Russia can be explained by the inertia of economic processes, asymmetric dependency, a vast group of countries that have not joined the sanctions, and the agile policies of the RCB. However, the main reason for Russia's unexpected economic resilience (not anticipated by Western policymakers) has been its soaring foreign trade surplus and, consequently, its fiscal surplus due to the collapse of imports, while its revenues from energy exports have surged. The incapacity of the West to swiftly substitute Russian fossil fuels has occurred because of a gradual rise in U.S. tight oil production and OPEC's refusal to bump up crude output in an environment of deteriorating economic outlook.

So far, the economic costs of the war (about $400 million per day) and the slow burden of sanctions have not appeared extremely disastrous for the Russian economy, but the first signs of increasing challenges in the financial system have emerged: the budget deficit has begun to gain momentum, tax collection has fallen, and inflation has remained at double-digit levels. In the country's "real sector" of the economy, some industries have already felt the chilly effect of multiple sanctions, including: automotive (where production has declined by 85 percent), air transportation, steel, telecommunications, textile manufacturing, chemicals, and pharmaceuticals.

Overall, the Russian economy is on track for a deep recession, even amid puzzling hints of temporary respite. While half a year of conflict has confirmed that sanctions *per se* cannot spark a regime change or stop the war, they are undermining Moscow's ability to wage a protracted, endless war. How long the military confrontation in Ukraine will last and what exit policy will be available will ultimately be determined on the battlefield and likely shaped through back-channel diplomacy. In the longer run Russia will cease to be the main supplier of hydrocarbons to Europe and will pay a high price for decoupling from advanced economies by accelerating its own technological backwardness.