Russia: tougher sanctions widen disconnect between currency and economy, increasing retaliation risk

The Russian rouble's fortunes are increasingly disconnected from the health of the Russian economy as international sanctions tighten in response to the war in Ukraine. The EU's proposed new sanctions are likely to inflict further damage on the Russian economy depending on the details of the final agreement, with increasing risk of retaliatory measures from Russia.

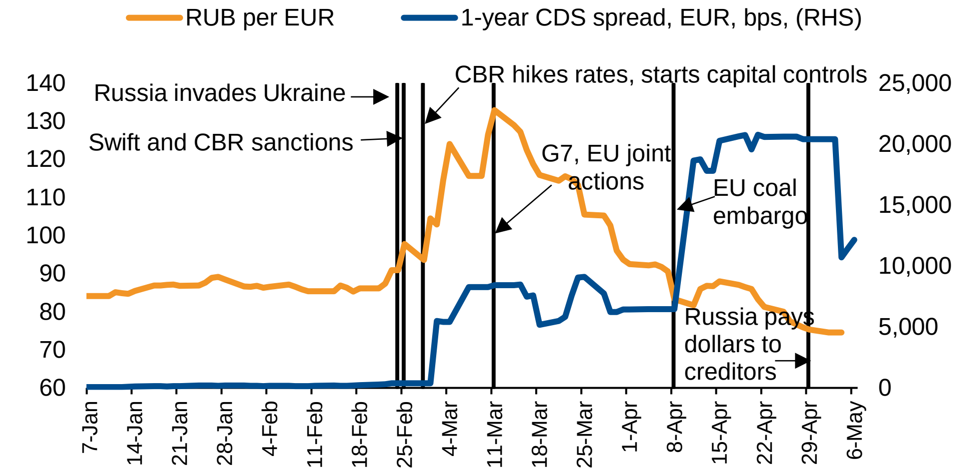
To take stock of Russia's economic fortunes in the third month of the full-scale war in Ukraine, we look at the prospects for growth given the sanctions already in place, the factors explaining the rouble's recovery, what impact new EU sanctions might have, and what the Russian authorities could do in response to such sanctions.

1. Rouble recovery – is it sustainable?

Two main factors explain the recovery of the rouble. Firstly, high foreign-currency inflows from oil and gas exports – as energy prices have soared – create steady demand for the Russian currency. In the first three months of this year, the current account surplus surged to almost USD 60bn, already nearly half of its USD 122bn full-year surplus of 2021 (**Figure 4**, on page 3). An oil embargo would hit foreign-currency inflows in 2023. This would have material implications for the value of rouble, particularly if today's high energy prices subside.

Secondly, while efforts by the Central Bank of Russia to prevent capital flight and stabilise local markets through capital controls and higher interest rates are working near term, they come at cost of tighter financial conditions than before the escalation of the war due to elevated credit spreads and low liquidity **(Figure 1**), decoupling economic and financial-market activity from the fortunes of the rouble.

Figure 1: Russia: exchange rate vs sovereign credit default swap (CDS) spreads



Source: Central Bank of the Russian Federation, Refinitiv Eikon, Scope Ratings

2. What are the near- and medium-term growth prospects for Russia?

We project Russia's economic output to contract by at least 10% this year – the steepest decline since 1994 – and stagnate in 2023, knocking activity back to levels last seen on the eve of the global financial crisis in 2008. To blame are the collapse in private consumption, in investment and in imports as sanctions have taken hold. Russia's important non-extractive industries – machinery and electrical equipment, computers, cars and pharmaceuticals – are reliant upon imported components. The share of foreign value added exceeds 50%, with about half of this coming from the EU, the US, the UK, Canada and Japan (**Figure 2**, next page). With many foreign firms halting activities in Russia since the escalation of the war, such a big portion of foreign-made goods cannot be easily substituted by imports from China or local alternatives.

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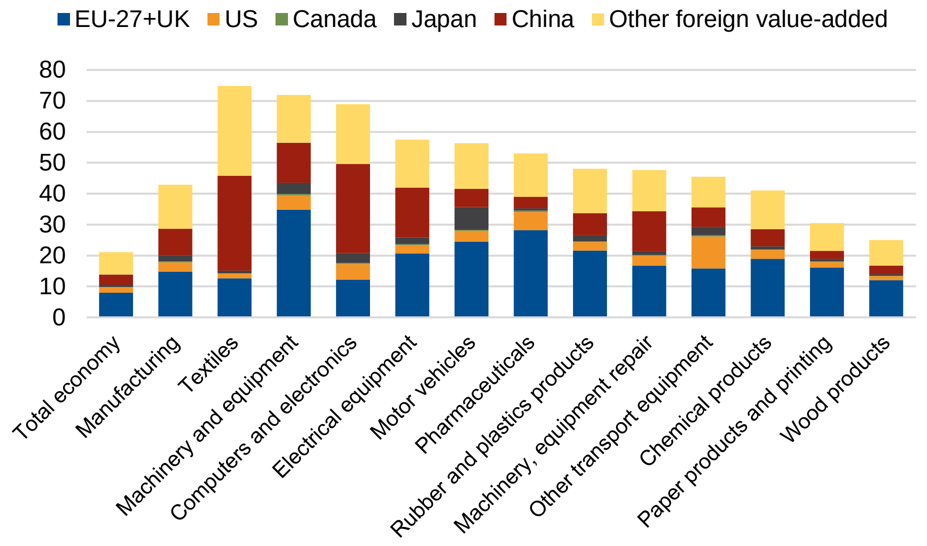
Figure 2. Share of *foreign* value added in final demand by industry in Russia, 2018
%



Source: OECD, Scope Ratings

Russian economy faces challenging medium-run outlook

Transforming Russia's economic model to sustain the country's greater economic isolation will require more than just protecting the value of rouble. More profound reform ought to wean the Russian economy off reliance on oil and gas. Such dependence has discouraged private investment, held back productivity and aggravated economic inefficiencies. Such reforms are politically costly, as they require reducing the state's large role in the economy.

Thus, the war in Ukraine represents a double setback for the Russian economy in the shape of further sanctions and neglect of long-standing socioeconomic problems. In the absence of significant restructuring of the economy, and assuming sanctions remain in place, we expect Russia's medium-run growth potential to moderate to 1-1.5% a year (from a previous estimate of 1.5-2%), well below that of most central and eastern European economies where living standards are far higher.

3. The EU proposes new sanctions – how tough are they?

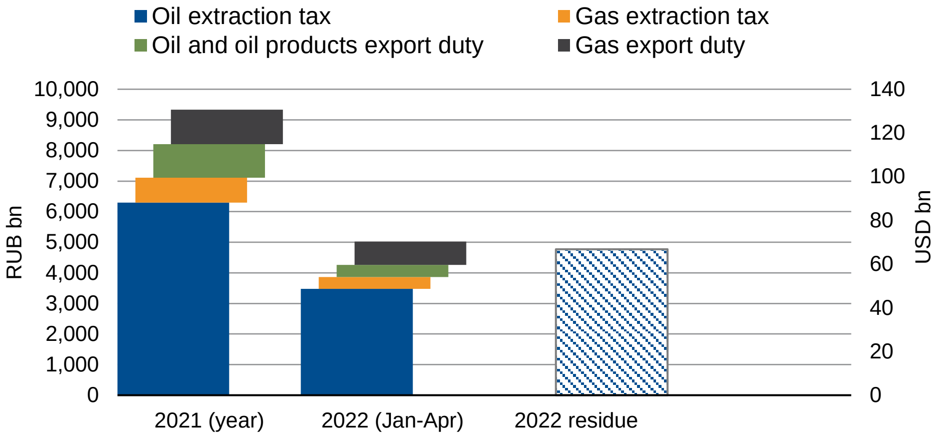
In the short term, possibly higher fuel prices should help offset impact of EU oil embargo

The Russian economy and budget rely heavily on revenues generated by oil and gas exports. An oil embargo would further box in Russia as oil has historically been much more important than gas for Russian state finances. Last year, oil and gas together generated 36% of Russia's federal budget revenues, with oil accounting for 80% of this aggregate.

In the short term, the hit from an oil embargo could be somewhat compensated for by possibly higher energy prices. In the first four months of 2022, Russia's federal budget already collected 50% of a planned RUB 9.5trn (or USD 132bn) in oil and gas revenue (**Figure 3,** next page). Russian Urals crude priced averaged USD 70.5/barrel in April, which was still higher than a budgeted USD 62.2/barrel, despite a heavy USD 35/barrel discount compared with Brent. Besides, Russia's exports excluding energy almost cover all goods imports, implying some degree of flexibility in face of the planned oil embargo.

In addition, while gas plays a lesser role for the state budget, Russia has generated more *export* revenue from gas than oil since the escalation of the war due to soaring gas prices and the discounts on Russian crude oil -- income which could be indirectly redistributed in the domestic economy.

Figure 3. Oil and gas revenues in Russia's 2021 and 2022 federal budgets



Source: Ministry of Finance of the Russian Federation, Scope Ratings

EU oil embargo likely to be softer than expected…

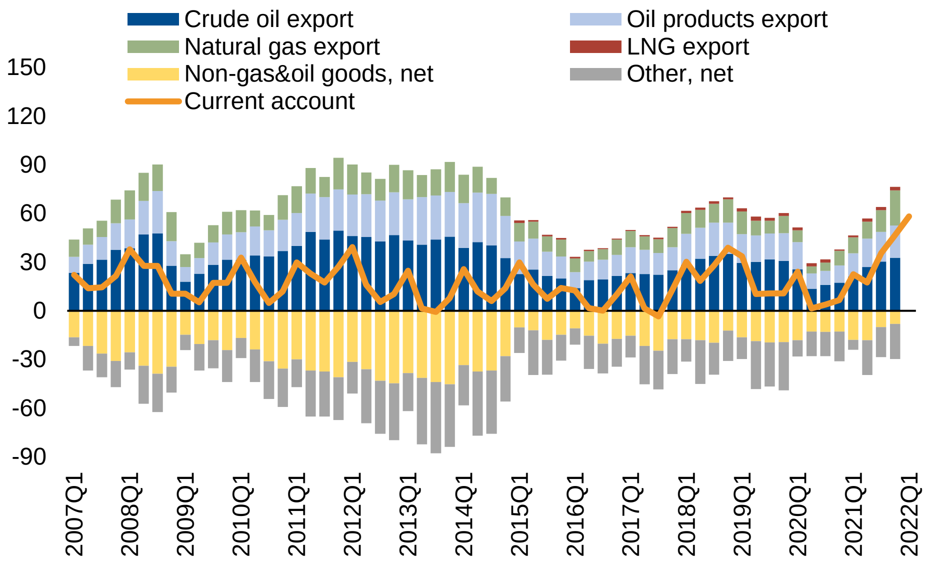
In the longer term, an EU boycott of Russian oil is likely to imply significant costs for the Russian energy sector and real economy in terms of rouble convertibility, depending on the details of the final agreement.

Opposition to some proposals from different EU member states, including to a ban on EU-owned vessels transporting Russian oil to third countries, implies that the final sanctions might be softer than initially expected, as any agreement requires unanimous endorsement of the EU's 27 member states. The EU will likely have to give some landlocked countries most dependent on Russian oil – Hungary, Slovakia, the Czech Republic – temporary flexibility to get such an embargo agreed.

…but will have long-term impact on Russian economy

Nonetheless, if the EU's proposed phased-in ban of Russian oil imports were coupled with secondary sanctions on maritime insurance, this would make it increasingly challenging for Russia to ship oil to Asia. Russia currently has limited options for immediate redirection of oil to Asia, as we explain on page 4.

Figure 4. Composition of Russia's current account balance
USD bn



Source: Central Bank of the Russian Federation, Macrobond, Scope Ratings

4. Countermeasures: what steps might Russian authorities take?

Russia may expand economic retaliation against the EU

Russia is likely to expand economic retaliatory measures against EU member states, including further interruptions of Russian exports to select EU countries, following Moscow's decision to stop gas supplies to Poland and Bulgaria. The presidential decree from earlier this week prohibits Russian entities from exporting products and raw materials of Russian origin as well as concluding foreign trade contracts under Russian sanction.

In the meantime, the Russian government is seeking alternative buyers for Russian oil and gas given acceleration of EU plans to shed its dependence on all fuel imports from Russia. Most likely alternate buyers are China and India, but a complete replacement of the European market is out of reach any time soon.

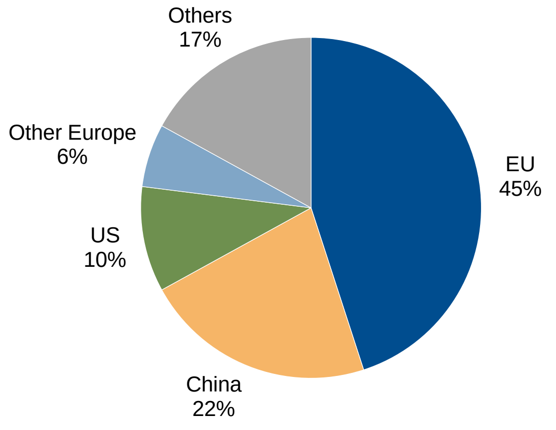
Redirecting oil to Asia limited by transport, logistical constraints

Russa's energy infrastructure is predominantly geared to the west. In 2021, half of Russian oil exports (crude oil and refined products) went to Europe (**Figure 5**). China was the single largest buyer of Russian oil, accounting for about 20% of Russia's oil exports, equally split between pipeline and seaborne supplies.

Redirecting Russian EU-bound oil and gas to the east is easier said than done without investment in new transport infrastructure, given transport limitations and logistical bottlenecks. Immediate expansion of pipeline oil supply to China is limited due to capacity constraints. As for oil supplied by tanker, while China's independent refiners are motivated to buy Russian oil at hefty discounts, state-owned commodity traders might hesitate due to concerns about their exposure to secondary US and EU sanctions. In addition, China's zero-Covid policy and widening lockdowns are complicating the unloading of Russian shipments.

Capacity to ship oil to Asia by rail is currently more constrained than usual after EU ban of Russian coal imports. In 2021, coal already accounted for more than half of the volume of total export cargo traffic of Russian Railways.

Figure 5. Russia's export of crude oil and oil products by destination, 2021
%



Source: IEA, Scope Ratings

Sanction risks affect Asian appetite for Russian oil

In March, China cut back its purchases of Russian oil by 14% compared with the same month last year. Meanwhile, India bought more than twice as much crude oil from Russia in March and April as it did during the whole of 2021, taking advantage of discounted prices, but Russia's Finance Ministry has forecast that Russian oil output might decline 17% this year amid sanctions and exits of foreign oil companies and these companies' needed expertise, complicating oil extraction amid shrinking demand.

Russia might need to continue offering sizable discounts on its oil to Asian buyers, worth taking the risk of secondary sanctions and cost of building new infrastructure.

Russian gas pipeline capacity still limited for supplying China

For gas, the capacity of Russia's eight pipelines suppling gas to Europe is around 220bcm/year, almost five times that of one pipeline to China, which, at full capacity, will reach 48bcm/year. The gas supply from Russia to China has more room to increase, but only in the longer term. The planned Power of Siberia 2 pipeline (to deliver an extra 50 bcm/year gas to China) might come on stream only by 2030.

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