

Research Russia

EU embargo on Russian energy could be a game-changer

- In this paper, we will discuss the sanctions' impact on Russian economy, and highlight that the EU decision to join UK and US in energy embargo would significantly increase the impact of existing sanctions packages.
- Looking beyond the initial hit to activity, the stagnation caused by Russia's isolative policies since 2014 will deepen further, causing long-lasting hardship on regular households' standards of living.

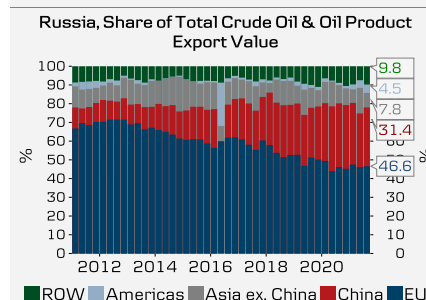
Russia's export-oriented economy will without a doubt suffer significant economic damage from the sanctions, but details still matter a lot in terms of gauging the magnitude. Russia has been running a current account surplus throughout the past years, which IMF estimated at 5.7% in 2021, and total exports are worth around 1/3 of Russia's GDP. While Russia, as a part of its push to increase economic independence ('Fortress Russia') has been able to reduce its dependency on the western trade, EU's decisions on sanctions still have a significant effect, given that EU accounts for 40% of Russia's total exports.

Around 50% of Russia's exports consist of energy, which means that the possible embargo would increase the sanctions' impact considerably. From Russian perspective, oil and petroleum products are relatively more important, as they account for almost 79% of Russia's total energy exports. Based on Russian customs data, around 50% of oil and oil products export value comes from sales to EU countries. In contrast, natural gas trade is more important for Europe, as it would be difficult to completely replace the Russian supply (see *Research Euro Area - Rising stagflationary headwinds from Ukraine conflict*, 28 February), which explains why oil is the more likely option for the EU embargo. The share of exports to China has increased steadily over the years, but remains smaller compared to EU, at slightly above 30%. China has so far remained relatively neutral over the sanctions, balancing its close relations with Russia against the West's relatively higher importance in international trade.

China could potentially cushion some of the decline in Russian exports, as it has previously purchased oil from countries under western sanctions, such as Iran and Venezuela (see *Bloomberg*). Nevertheless, Russia's exclusion from SWIFT has already affected trading with China as well, as despite both nations' efforts to develop local payment systems, most of the bilateral trade is still conducted over SWIFT (see *Global Times*). So far, only a limited number of larger Russian banks have been excluded from SWIFT (e.g. Sberbank still included), so concrete near-term implications remain uncertain.

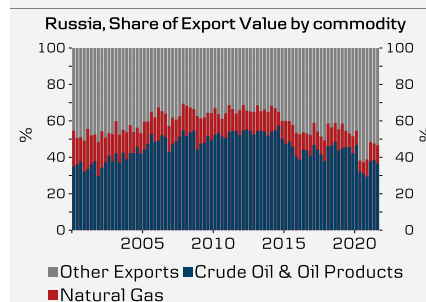
Aside from practicalities of sanctions, logistics could also be an issue, as especially natural gas trade is difficult to re-route. The key natural gas pipeline from Russia to China is not connected to the western pipes, even though Russia has plans to increase capacity towards east (see *Reuters*). Oil is more easily transported, but currently around 63% of Russian oil is transported via Baltic, Black and Arctic seas, far away from China. Consequently, *IEA has estimated* that even without an EU embargo, Russian oil exports could drop by around 40% already in April, which we also reflected in our latest *FX Forecast Update - Global monetary tightening favours the USD*, 18 March.

EU is a key trading partner for Russia



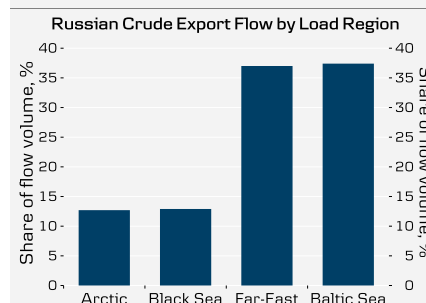
Source: Macrobond, Customs Service of Russia

Energy sanctions matter for gauging economic impact for Russia



Source: Macrobond, Rosstat, CBR

Most of China's current Russian oil comes from the Far-East region



Source: Refinitiv

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In addition to a possible halt in exports, the economic isolation also means interrupted access to global supply chains. Key import goods categories include manufactured products such as cars, and inputs for industrial production, and possible sanctions would come on top of the existing global supply chain problems. While Russia has been able to diversify its imports away from the west following earlier sanctions, EU still accounts for 40% of the import value, meaning that complete halt to trading would mean serious disruptions (see our pre-war analysis at *Research Russia - Expect serious market disruptions if a war breaks out*, 14 January).

Long-term outlook was not strong to begin with

Since 2014, Russian GDP growth has been modest and the pre-war medium term outlook was not rosy to begin with. In the early 2000s, the annual growth in Russian GDP varied in the range of 5-10%. Growth was largely driven by a rise in household consumption, while investments also grew. In the early 2010s, growth started to moderate and in 2015, post the Russian annexation of Crimea, GDP shrank by 2%, but it has been estimated that most of the reduction in GDP at the time was due to a fall in oil prices, while the negative impact from sanctions has been estimated only at around 1%-point.

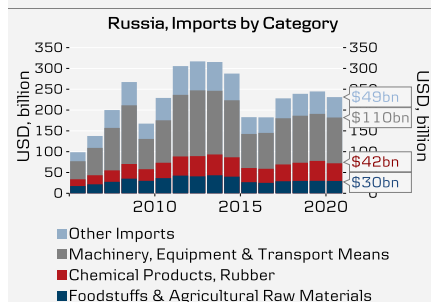
Since 2014, the annual GDP growth has been markedly slower than in early 2000s as growth in both consumption and investments has stalled. The IMF pre-war estimates for the Russian economic growth in 2022-2026 were in the range of 1.6-2.0%. The weak starting point highlights the several weaknesses in the Russian economy: aging population and weak productivity growth implying a weak demand for investments and a stalled growth in real wages hampering private consumption.

After the Russian invasion into Ukraine on February 24th, inflation in Russia has accelerated rapidly. Weekly inflation has now twice exceeded 2% implying an unprecedented high inflation, which will have a substantial negative impact on private consumption, as wages will not be able to adjust as quickly. Investments have barely grown since 2014 and the ongoing uncertainty, a broad-based withdrawal of western businesses from Russia resulting from sanctions or voluntary boycotts, and the heavy toll from the sanctions on key Russian financial institutions will further weigh on investments and employment. Brain drain, as highly educated people that disapprove Putin's politics are now seen leaving Russia, is a further drag on productivity and likely to have long-lasting negative effects on potential growth.

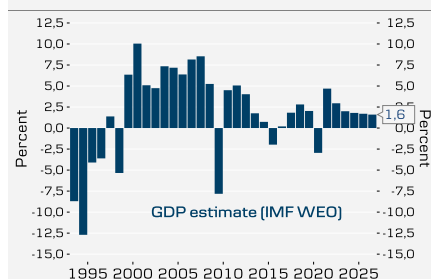
Net exports is only around 3% of the Russian GDP. In the absence of further sanctions on Russian energy trade, the Russian economy will continue to benefit from hydrocarbons exports while imports are likely to take a big hit from the now-imposed sanctions. Hence, in the short term, if the EU abstains from imposing an embargo on Russian energy imports, the impact from net exports to the Russian economy could even be positive, compensating for some of the economic losses in consumption and investments. In the current situation, the energy trade also provides Russia the otherwise restricted access to foreign currencies.

Despite net exports potentially providing some cushion, and even in the absence of an EU embargo on Russian oil imports, we expect a marked drop in Russian GDP growth in 2022. Even before the sanctions-driven supply shortages, manufacturing activity was subdued in February with PMI falling below the 50 threshold for the first time since September. Service sector activity will also take a severe hit from the erosion of consumers' purchasing power. Consensus projects -8% GDP growth in 2022, in line with CBR's monthly survey of analysts, and also in line with the 2009 GDP reduction, which was the worst collapse since mid-1990s.

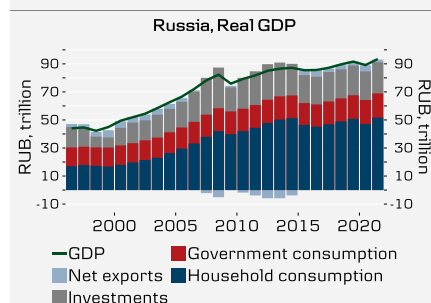
Sanctions could further worsen supply chain problems



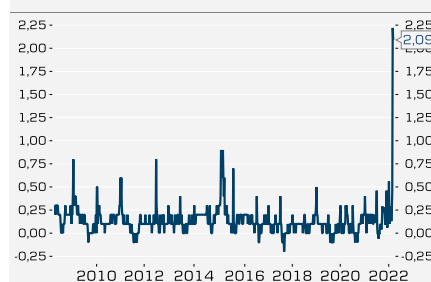
IMF pre-war estimates for Russian GDP already signalled weak growth



Private consumption has been the main driver for growth. Domestic demand now expected to slow down markedly.



Weekly inflation rate has now twice exceeded 2%



Looking beyond the initial hit to the activity, the economic isolation caused by both sanctions and voluntary boycotts will likely last way longer than the war itself. The stagnation caused by the Fortress Russia policies, including lack of foreign investments and declining trade, will likely deepen further, weighing on Russian households' standards of living, especially relative to other economies. Russian nominal GDP per capita in USD increased over seven-fold from 2000 to 2013, but then declined over 36% by 2020. For comparison, the GDP per capita in USD was over twice that of China in 2013, which surpassed Russia in 2020. While Putin's approval ratings have initially been estimated to have increased in March, the economic hardship for households could reverse the course over the longer run.

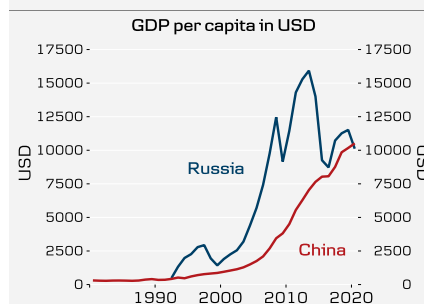
EU energy embargo a potential game-changer?

In case of an EU embargo on Russian energy imports, Russian access to foreign currency apart from e.g. the Chinese yuan would be severely disrupted. A severe collapse in foreign exchange receipts would add substantial pressure on the federal government budget, which already ran a pandemic-induced deficit in 2021. In pre-war economic projections, the federal government budget was expected to be balanced in 2022, but this picture would change markedly if energy exports to EU was to be banned.

In a scenario, where EU imposed an embargo on Russian energy imports, we see a higher likelihood of an increase in federal government debt to finance the deficit. In the absence of foreign investors, we think the central bank would be forced to take an active role in financing the deficit, raising the likelihood of inflation spiralling out of control. This would further weigh on the consumers' purchasing power, domestic demand and economic growth. Perhaps even more importantly, such decision could potentially disrupt the capacity of the Russian government to pay for its federal employees, including the military personnel and the police. Obviously, monetary financing, which is possible, would still allow a continuation of payments and salaries in RUB, but a further accelerating inflation would erode the salaries' purchasing power. We think this would significantly undermine stability in Russia and raise the risk of social unrest while also weakening the morale of the Russian army.

Hence, we believe an EU embargo on Russian energy imports could become a potential game-changer – a factor that, in the best case, could end the war. The price would be high for Europe in the short term, but over time, European economy would adjust. Price for the Russian economy would be substantially higher and the negative impacts much more long-lasting.

GDP per capita in Russia has declined since 2013



Source: IMF, Macrobond

Annexation of Crimea boosted Putin's approval ratings. Support has again increased over the last months.



Source: Levada Center, Macrobond

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Antti Ilvonen, Analyst and Minna Kuusisto, Chief Analyst

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None

Date of first publication

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