Macro Focus Russia

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13 February 2019

Sanctions against Russia: the known unknown

- **In 2016-2017, Russia got used to the 'new normal' of the sanctions; 2018 added a new and different layer as new sanctions were less tethered to specific policy objectives**
- **We expect further sanctions by the US going forward and no relief of the current sanctions**
- **This 'known unknown' of new sanctions has increased uncertainty**
- **We do not expect further sanctions to derail the Russian economy**
- **Over the past years, the Russian government has geared its economic policy towards making Russia more shock-resistant…**
- **… However, this policy came at the expense of lower economic growth**

Sanctions, part I: 2014 and the annexation of Crimea

Sanctions against Russia were instituted because of the Ukraine crisis. In March 2014, the European Union (EU) and the United States (US) imposed sanctions against Russia in response to its illegal occupation of Crimea and support for secessionist groups in eastern Ukraine. At first, these were individual sanctions against specific people and companies. Then, in July 2014, additional sectoral sanctions were imposed that limited foreign financing of public banks and oil and gas companies, and restricted Russian oil and gas companies' access to advanced production technologies. In response, Russia imposed an embargo on a wide range of agricultural products from Western countries in August 2014. We concluded in our publication of July 2017 (Macro Focus: sanctions against Russia the New Normal) that sanctions for Russia were the 'new normal' and that further sanctions could not be ruled out.

Sanctions, part II: 2017 and a broader sanctions framework

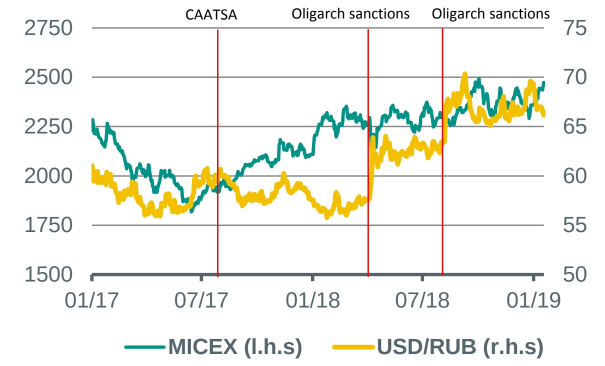
Since then, things have gotten worse. The US imposed new sanctions, including the Countering American Adversaries Through Sanctions Act (CAATSA) of 2017 and the 'oligarch sanctions' of April 2018 (see: From Russia with Love) and August 2018 (see: Sanctions looming) (see table below). These latter rounds of sanctions were less tethered to specific policy objectives, as the 2014 sanctions were. The CAATSA framework was created to incorporate the existing sanctions and implement new sanctions related to a range of issues, such as corruption, cybercrime allegations and Russian support for the

Assad regime. The April and August 'oligarch sanctions' were directed against oligarchs benefiting from a corrupt system.

Developments in 2018 on sanctions against Russia	
April	**Sanctions**
	Reason: election interference, cyber hacking of several international nonpolitical organizations, and the March 2018 Novichok nerve agent attack
	17 government officials
	7 oligarchs
	12 companies (including EN+ Group and Rusal)
	State-owned Russian weapons trading company
	The Russian Financial Corporation Bank
August	**Sanctions**
	Reason: Russia used chemical weapons in violation of the Chemical and Biological Weapons Control and Warfare Elimination Act of 1991 (CBW Act).
	Arms Sales Financing
	Denial of US Government credit or other financial assistance
September	**Executive order**
	Reason: Imposition of sanctions on parties determined to have interfered in or undermined public confidence in US elections
	Under the EO, the Director of National Intelligence has 45 days after each elections to assess whether any foreign interference occurred.

Sanctions in 2018 coincided with turmoil at markets

% growth, yoy

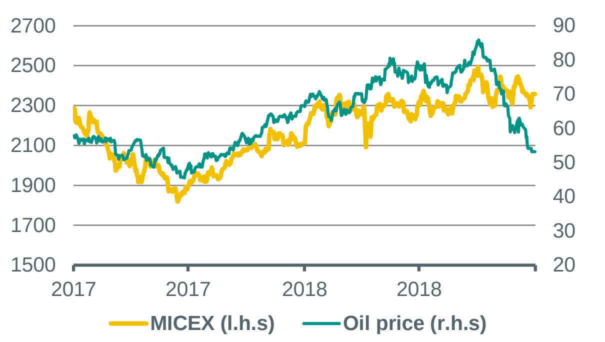


Source: Bloomberg and ABNAMRO Group Economics

Drop in oil prices halted equity gains

MICES Equity index

Brent oil price USD/bbl



Source: Bloomberg

Sanctions exacerbated macroeconomic challenges

Sanctions in 2017 had a short-lived negative effect on the ruble, the equity index and CDS spreads. When Russia imposed counter-sanctions, which restricted imports of products such as agricultural goods from the EU and US, import inflation took a hit. Due to the decisive government intervention and inflation-targeted policy of the Central Bank of Russia, the panic waned off quickly. That said, the sanctions did exacerbate the macroeconomic challenges, in particular the sharp drop of the oil price in 2014 that Russia faced.[1] The economy went into recession in 2015 and it took two full years for it to recover.

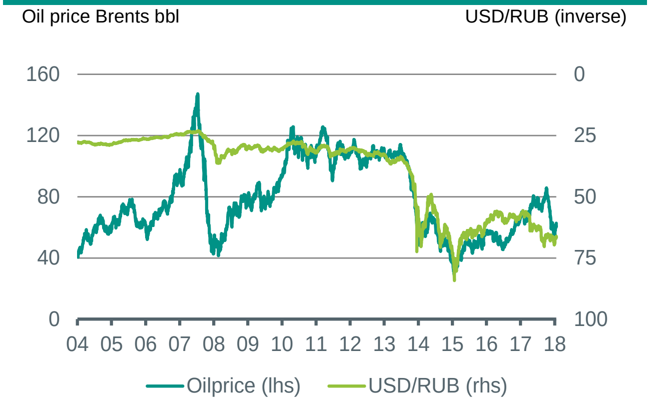
A new ingredient in the mix

While, in 2016-2017, Russia got used to the 'new normal' of the sanctions, 2018 added a new and different layer. The two rounds of 'oligarch sanctions' in 2018 had a severe effect on markets, and the April round resulted in one of the worst days for the Russian markets since 2014. While oil prices were still on an upward trend in 2018 (peaking in October), the associated appreciation of the ruble ended abruptly in April 2018 when the first round of tougher sanctions was imposed. These sanctions were accompanied by broad

[1] Please note that the sanctions against Russia are specifically designed to have a limited and targeted economic impact. The sanctions do not prohibit economic activity in general as do the sanctions against Iran, but were put in place to target individuals and entities. Overall, more than 80% of the largest 100 firms in Russia are not directly affected by any US sanctions.

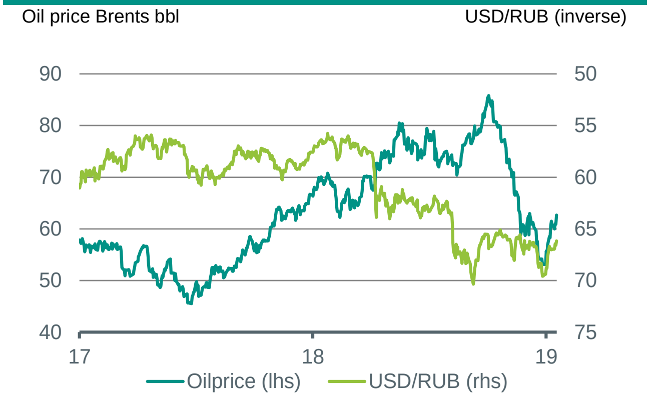
pressures on EM currencies[2], including the ruble, and may therefore have aggravated the impact of the sanction shock. Moreover, the sharp correction of Russian financial markets happened because of the broad scope of the new round of sanctions, rather than solely being imposed for the annexation of Crimea.

Correction between oil price and ruble…



Source: Bloomberg and ABNAMRO Group Economics

… less visible in the last two years



Source: Bloomberg

The road ahead for Russia sanctions

In our baseline scenario, we expect no relief of the existing sanctions. There are several factors preventing any meaningful relief of US sanctions. Since the enactment of the Countering America's Adversaries Through Sanctions Act (CAATSA) in 2017 in response to allegations of election tampering and cyber activities, US sanctions have been expressly separated from specific measures that Russia could take to remediate the situation. In addition, taking a hard-line stance on Russia has – in part due to the ongoing investigation of Robert Mueller into collusion by President Trump and his associates – become a highly politicised issue. The now Democrat-controlled House of Representatives is likely to want to pick up a number of bipartisan sanction initiatives (notably the Defending American Security from Kremlin Aggression Act (DASKAA) and Defending Elections from Threats by Establishing Redlines Act (DETER) bills) that have been on the backburner due to the mid-term elections in November and subsequent transition period until January. If enacted, these bills could significantly expand the sanction regime to include sovereign debt issuances. The chance of DASKAA and/or DETER being implemented in their current form seems to be slim under the current circumstances, also taking into account the far-reaching economic harm they would likely cause, not only to Russia but to the broader global economy. However, we do expect new rounds of businesses and individuals being targeted under the US sanction regime. This 'known unknown' of new sanction rounds is continuing to have an impact on markets as foreign investors and businesses are extremely cautious about doing business with their Russian counterparts.

[2] EM currencies were hit by higher US yields, the recovery of the dollar, trade tensions between the US and China, and country specific challenges.

One swallow does not make a summer

The lifting of US sanctions on businesses tied to Russian oligarch Oleg Deripaska in January 2019 was interpreted by some as an indicator that further limited sanction relief may be on the cards. This is indeed a positive sign because it shows that sanctions, whose purpose is to change the behaviour of the target, can be lifted when the target starts to comply (as Deripaska's companies did). However, we do not expect extensive further relief to come to pass, largely because the semblance of weakness with respect to Russia will become increasingly problematic and politicised as Robert Mueller's findings will start to become public in 2019.

No relief from EU expected either

The EU, for its part, is unwilling to consider sanction relief in the absence of meaningful progress towards the Minsk II agreement. Yet the deal is fundamentally flawed; Russia has thus far proven to be unwilling to withdraw its heavy weaponry from the region, and Ukraine recently enacted legislation that obstructs the promised autonomy of Donetsk and Luhansk while enabling Kiev to criminally prosecute persons cooperating with the separatists. 2019 will be an election year in Ukraine (presidential elections in March, parliamentary elections in October). For this reason, we do not expect any conciliatory initiatives as candidates will want to avoid seeming weak on Russia. Although there are several EU Member States that are critical of sanctions (e.g. Hungary, Greece and Italy), these countries lack the broader leverage to force a change in EU policy and have other (more pressing) issues to address than the Russia sanctions. They would rather use their bargaining chips with the EU on those issues than on the Russian situation.

Alternative scenario: a turn for the worse

If the Mueller investigation finds tangible evidence of Russian electoral interference and collusion by President Trump, harsh further sanctions are to be expected, either under the (possibly amended) DASKAA/DETER bills or via yet-to-be-drafted legislation. The risk of this scenario is that, the further sanctions become removed from Minsk II and the original reason (Russia's military actions in Ukraine), the more difficult it will be to lift these sanctions and to de-escalate. US sanctions against countries such as Iraq, Iran or North Korea are very clear reminders of this.

With regard to the EU, we expect that further (targeted and, less likely, sectoral) sanctions would only be considered in the event of Russian escalation of hostilities against Ukraine or further intelligence operations by the Kremlin on European soil.

Alternative scenario: a change of course

While we expect US-Russian relations to remain hostile and sanctions to remain in place, we see a potential avenue that could lead to normalisation of ties and partial relief of sanctions between the EU and Russia. If the foreign policy gap between the US and the EU continues to grow, the EU may diverge from the US sanction policy by reconciling with Russia. Not only do European companies have closer commercial ties to Russia than their American counterparts, but the EU also has a strong incentive to prevent Ukraine from being subjected to prolonged economic and political upheaval. For this reason, we believe that Germany and France may well initiate a new diplomatic drive to kick-start the implementation of Minsk II (depending on a change in Russian attitude). A possible starting point would be to work out a Russian proposal to allow peacekeepers in the Donbass.

Prudent policy has made Russia more sanction-resilient

In our baseline scenario, we expect sanction uncertainty to remain high as potentially new sanctions will be introduced in 2019. In order to determine the effect of our baseline scenario on the Russian economy, we have to takin into account the policy response by the Russian government. Over the past few years, the Russian government has geared its economic policy towards make Russia more shock-resistant. It focused on (1) prudent fiscal policy and reserve-building, (2) import substitution and diversification of exports, and (3) inflation targeting.

(1) *Prudent fiscal policy and reserve-building*

Russia has brought its gross external debt down, from USD 668bn in December 2013 to the current level of USD 536bn. External debt-to-GDP is below 30%, which is relatively low by emerging market standards. Russia used its ample reserves to help sanctioned businesses and stimulate the economy, and FX reserves dropped from nearly USD 500bn in 2012 to a low of USD 318bn in 2016. Policies aimed at restoring reserves – such as the fiscal rule, introduced in 2017, that channels oil revenues into the reserves – have helped to increase FX reserves to the current figure of USD 400bn. It covers almost 10 months of imports. This gives Russia a comfortable cushion against future internal and external shocks. Meanwhile, the Central Bank of Russia has divested most of its US Treasury holdings, while accumulating more gold, suggesting they are preparing for the worst-case scenario. The government also raised oil industry taxes, hiked value-added tax and sharply increased the pension age in the course of 2018. These actions were also taken in light of the government budget, as Russia aims to create a fiscal surplus in the coming years in order to not let government debt rise.

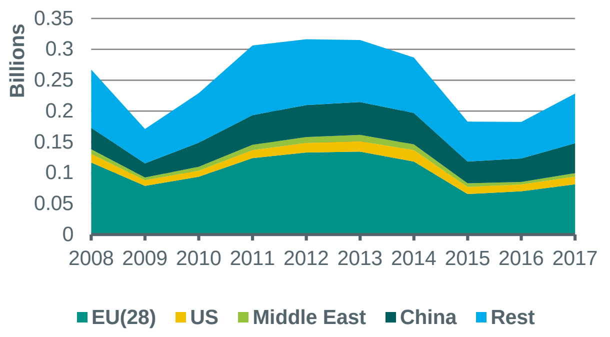
(2) *Import substitution and export diversification*

After the implementation of sanctions in 2014, trade with the EU-28 came under pressure. Russian imports from the EU-28 as a percentage of total imports decreased from 42% in 2013 to 35% in 2015. Sectors that were targeted by sanctions in particular saw a sharp drop in import from the EU-28. Imports related to technology dropped by 56% from 2010-2013 to 2015-2017. The share of import in food consumption declined from 36% in 2014 to around 20% in 2017, mainly due to the counter-sanction imposed by Russia. Imports of such products as vegetables, fruits, fish and meat, and milk and cream dropped to 0% in 2015. A new government commission on import substitution was established in 2015, whose main aim was to replace sanctioned and/or strategically important imported goods by domestic production. Trade data suggests that import substitution has not taken off yet, as many of the sanctioned goods, such as agricultural products, are now being imported from non-EU-28 countries. To illustrate, imports of sanctioned dairy products from non-EU-28 countries has tripled.

Moreover, Russia actively pursued diversification of its export destinations. Non-oil exports to non-Western countries have increased over the last two years, which may point to export diversification. That said, much of this increase is due to China. Given that the Chinese economy is growing at a fast pace, it is little wonder that exports to this country have increased. Moreover, Russia has established some strategically important partnerships, especially with China. As the US sanctions impact the modernisation of the Russian military, the country searched for alternative suppliers of defence ordnance and made several deals with China and other Southeast Asian countries. Moreover, China has provided loans to gas companies Novatek and Gazprom.

Russian imports from different regions

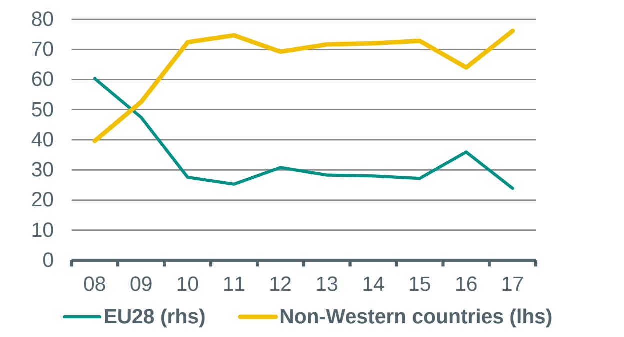
Import, value in USD (thousands) total all products



Source: UN COMTRADE

Russian non-oil exports

Non-oil exports to EU-28 and non-Western countries as a % of total non-oil exports



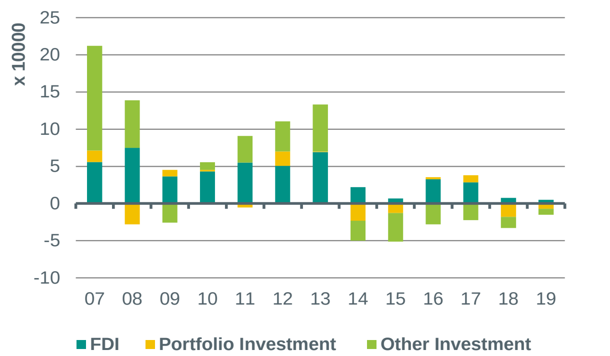
Source: Bloomberg

(3) *Inflation targeting*

The Central Bank of Russia (CBR) responded promptly to the rising import inflation in 2014 by hiking rates from 5.5% at the beginning of 2014 to 17% at year end. As we wrote in our latest Russia Outlook (Russia Outlook 2019: Muddling Through), the CBR has consistently pursed a conservative monetary policy – with relatively high real interest rates compared to other emerging markets – in order to anchor inflation expectations at their target rate of 4%. This has helped to bring inflation down from a peak of 17% at year-end 2014 to a current level of around target. Price stability has helped the overall recovery of the economy. Moreover, inflation expectations have come down significantly from the high levels of the past years. This hawkish central bank policy came at the expense of higher interest rates for businesses, which have curbed credit growth and investments. Loans to SMEs are still below the level seen in 2013.

Capital flows lower since 2014

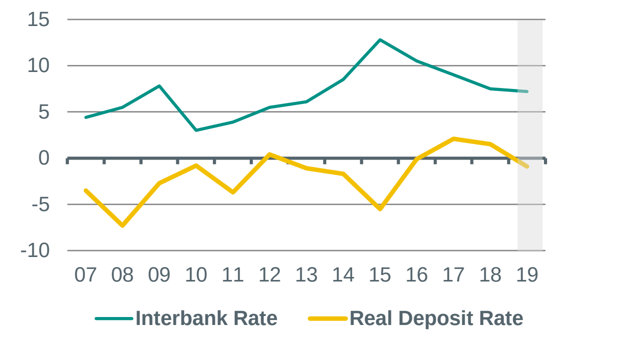
Non-resident Capital Flows. USD million



Source: EIU and ABNAMRO

Real rates have remained positive over the past years

Interest rates, %



Source: Bloomberg

Stability over growth: do not overdo it

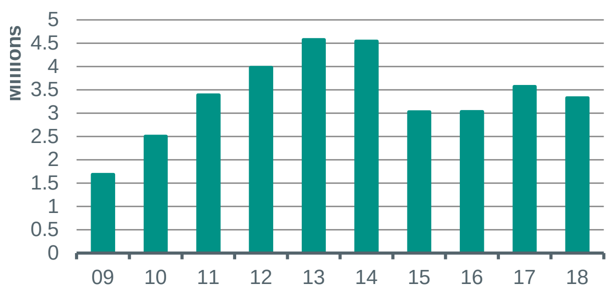
Macro-economic stability has been at the forefront of Russia's strategy to cope with the new normal of sanctions. And active prudent fiscal and monetary policy has increased Russia's resilience to internal and external shocks. Moreover, while new sanctions in 2018 came largely as a negative surprise for markets, more sanctions are widely expected in 2019. For this reason, we expect that new rounds of sanctions against businesses and individuals – similar to the 2018 sanctions – will only have a short-lived effect on markets and will not derail the Russian economy. Furthermore, new sanctions will meet with an improving economic background as we expect a modest recovery of oil prices and a strong EM currency environment. We believe that sanctions affecting gas and oil exports and/or the issue of government debt would be the only ones to potentially throw Russia back into a recession. But, as predicted in our scenarios, we consider it unlikely that these types of sanctions will actually be imposed.

There is no such thing as a free lunch

Macro-economy prudency and shock-resilience comes at a cost. While Russia may be more sanction-resilient than it was before 2014, it is still dealing with a low growth environment. Since the recession of 2016-17, we have not seen any catch-up growth. Just the opposite, growth has been consistently below the 2% potential growth. High interest rates in combination with prudent and conservative fiscal policy has not helped growth rates. Credit growth is still below the level of 2013 and investments in productive sectors have been lagging as well. Russia aims to continue increasing FX reserves from a level of USD 400bn to USD 500bn, while some sectors with obsolete industry standards such as manufacturing are in desperate need of new investments in technology. Russia spends less than half of the OECD average on research and development. Macro-economic stability comes at the expense of lower future growth and the cost/benefit ratio should be weighted carefully.

Loans in RUB to SMEs

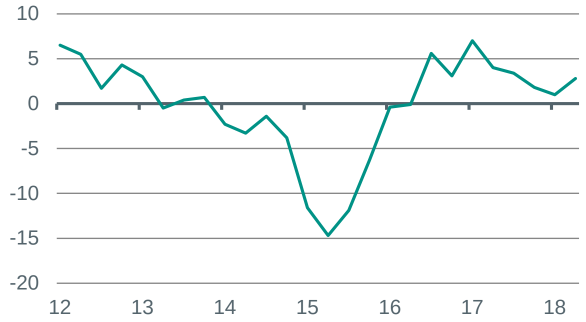
Loans to SMEs RUB millions



Source: EIU and ABNAMRO

Investments still lacklustre

Gross fixed capital formation, constant prices yoy % NSA



Source: EIU