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Policy Brief

The living cost crisis: How are the sanctioned economies of Belarus and Russia faring?

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Contributors:

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Executive Summary

How are the sanctioned economies of Belarus and Russia faring? This policy brief focuses on this question to explore whether and to what extent sanctions are working. As of late 2022, sanctions had significantly affected the economies of Belarus and Russia. Yet they have not been successful in achieving their primary objectives - as Russia has continued to finance its war in Ukraine and Lukashenka's regime is still involved in it and has not stopped severe political repression against its own people. This does not mean however that the Russian economy is not suffering, nor that it will not suffer further in the medium and in the long run. The voluntary departure of western firms, migration of its best talent, downward pressure on productivity through declining human capital, the EU's eventual energy decoupling, and Russia's inability to find equally good customers elsewhere will cause severe long-run damage to the Russian economy. This is also likely to have a major impact on Belarus in the future.

Background

Europe and the world are being hit by the unfolding energy, fuel, and living cost crises, as a result of Russia's war in Ukraine. While Putin struggles to gain the upper hand in 'his special operation' and keep public opinion on his side, Lukashenka's regime is being condemned by the international community as a co-aggressor and accomplice to the war in Ukraine, with all ensuing implications. Yet, on the surface, both co-aggressor economies remain relatively stable, fueling questions about the effectiveness of punitive measures and sanctions in particular, requiring a fresher approach to the issue. What are the consequences of the sanctions so far? How do the sanctions impact different social groups in Belarus? Do they have any effect on the leadership in Belarus and Ukraine? What does the Lukashenka regime try to do to circumvent sanctions, and cand the sanctions regime be revised to have a more direct impact on the Belarusian regime?

These and other questions were discussed at the expert webinar jointly convened by the Research Centre of Sviatlana Tsikhanouskaya Office (OST Research Centre), the Oxford Belarus Observatory and IGSD University of Warwick (Institute for Global Sustainable Development). The present policy brief is based on this event, which was moderated by **Julia Korosteleva,** Professor in Business Economics School of Slavonic and East European Studies, University College London, and the speakers of the event included **Aleś Alachnovič,** Sviatlana Tsikhanouskaya's Representative on Economic Reforms, Leader of CASE Belarus Team Economy; **Kateryna Bornukova,** Academic Director at Belarusian Research and Outreach Center; **Prof. Christopher Gerry,** Dean of Graduate School of Development, University of Central Asia and Oxford Belarus Observatory; **Michal Wyrebkowski,** Eastern Europe and Energy Research Lead at Yale Chief Executive Leadership Institute.

Analysis of the issue

Looking back over history, economic sanctions have rarely had their desired or intended effect. The literature shows that sanctions fail at achieving the stated goals in most cases.[1] Meanwhile, sanctions have been used as a foreign policy tool for a long time[2] and recently, the sanctions policy has become more comprehensive in the context of Russia and Belarus. In parallel, the broad-based use of economic sanctions raises questions about their effectiveness: to what extent do they have an effect on the targeted economy?

This policy brief focuses on the economic impact of sanctions imposed on Belarus and Russia. The Western countries imposed a comprehensive set of sanctions on Russia following Russia's full-scale invasion of Ukraine in February 2022. The Western actors, in the words of *The Economist* "have unleashed an unprecedented arsenal"[3] to stop Putin's war machine. Belarus is seen as a co-aggressor in this war because the Lukashenka regime allowed Russia to use Belarus territory for military intervention in Ukraine and supplied ammunition to the Russian forces. The sanctions have had major effects on those (and other) economies, which will be examined in detail below. In particular, rising energy prices and inflation in several countries due to the impact of the war destabilised the entire global economy. All these developments put additional pressure on businesses and households —undermining economic confidence, urging them to reduce their spending, and hampering the investment climate. In what follows, the impact of sanctions on Belarus and Russia will be examined, respectively.

Belarus and the sanctions

After the rigged presidential election of 2020, over 40 countries introduced different sorts of economic sanctions on Belarus. The EU, other European countries, the US, Canada, and the UK coordinated their sanctions policy. There are also distant countries such as Australia, New Zealand, and Japan that imposed sanctions on the Lukashenka regime. After the start of the war in February 2022, Ukraine also joined this number of countries.

What has been achieved so far? Sanctions imposed on Belarus can be separated into three broad categories: financial sanctions, trade sanctions, and personal sanctions.

Financial sanctions were implemented relatively quickly —for example, the freezing of cooperation with the public sector by EBRD, EIB, and EC. After the war, the World Bank also stopped any cooperation with Belarusian authorities. As a result of sanctions international markets are closed for Belarusian Eurobonds. Since April 2020, there have been no new bond issues, even on the Moscow Stock Exchange. Arguably, the Ministry of

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[1] For a recent critical review and analysis, see Daniel W. Drezner, "How not to sanction?" *International Affairs*, Volume 98, Issue 5, 2022, Pages 1533–1552.

[2] For a classical study on the topic, see David A. Baldwin, *Economic Statecraft*, Princeton University Press, 1985.

[3] The Economist, "Western sanctions will eventually impair Russia's economy," 24 August 2022.

Finance of Belarus saw that attempts to issue would likely fail. State-owned banks, which actually dominate the banking sector in Belarus, also experienced funding issues, as some of the Belarusian banks have been sanctioned or disconnected from the SWIFT system. All these steps resulted in a technical default on the foreign debt of the public sector of Belarus at the end of June 2022.

Packages of **trade sanctions** were implemented against state-owned enterprises (SOEs) and other enterprises in the *de facto* ownership of the regime. After the Ryanair incident and the start of Russia's full-scale war in Ukraine, there were packages against whole sectors of the Belarusian economy, including oil and petroleum products, potash fertilisers, metal and metal products, tobacco, and some others. As a result, Belarusian exports to Ukraine, US and UK almost disappeared completely, while those to the EU fell by around 70%[4].

Some private investors also left Belarus or stopped their investments in the country. Nevertheless, the trade sanctions are not very successful. Belarusian companies keep exporting and survive the sanctions to date (see the following pages for more on this).

The third category is **personal sanctions**. Some of the sanctions imposed on Belarus targeted private businesspeople and civil servants. As a matter of fact, these types of sanctions are relatively easy to avoid and limited in terms of scope. Very few people were sanctioned by the West and targeted individuals usually circumvent these sanctions by changing the name of the companies and replacing their owners.

The social cost of the sanctions in Belarus also needs to be assessed in this context to reveal the public mood. Sanctions led to a general decline in real wages, being much more pronounced in certain sectors (such as petrochemicals) than others, which were not directly affected by sanctions. Food exports to Russia and to the EU even increased, leading to higher wages in that sector. According to the BEROC consumer confidence survey, in general, this indicator is very low in Belarus.[5] After reaching the bottom in April 2022, consumer confidence has been restored, despite the fact that GDP continued falling in August 2022. Also, most of the real wage decreases were already realised during spring and summer and by the end of summer they started recovering. This suggests people adapted to the situation and started adjusting their expectations of the future, as they believe the worst effects of sanctions are already over.

Why did sanctions not change the behaviour of the regime? First, they were too slow and not sufficiently coordinated among countries. Second, there is still no special task force that will control the implementation of sanctions and fix them by closing the loopholes. Third, there is significant support from Russia, including cheap gas prices. Belarus buys gas at 128 dollars per 1,000 square metres,[6] while spot prices in the EU are above 1,000 — almost 10 times higher (November 2022). There are other mechanisms of support from Russia too. For example, the share of exports from Belarus to Russia increased from 40% to around 65% or

[4] People's Embassies of Belarus, "70% of Belarusian export to the EU is under sanctions", 27 March 2022. https://belarusabroad.org/en/2022/03/70-of-belarusian-export-to-the-eu-is-under-sanctions/

[5] For details, see BEROC's website, https://beroc.org/en/

[6] "Belarus pays for gas in Russian rubles, Jan-May fully paid up - energy ministry", *Interfax*, 20 June 2022.

even 70% after the war. There were also favourable external conditions, especially in 2021, that prices of several goods including those that Belarus exported skyrocketed.

Russia and the sanctions

Russia's support plays a major role in allowing the Lukashenka regime to counter economic sanctions. Since February 2022 however, Russia is also heavily sanctioned by the West. In this context, another central question is: how are the sanctions affecting Russia?

The Yale Chief Executive Leadership Institute led by Jeffrey A. Sonnenfeld has been one of the institutions that examines business withdrawals from Russia.[7] According to its report, since the start of Russia's invasion of Ukraine, over 1,000 western companies withdrew from Russia. This represents about a million directly related employees of these companies, of the subsidiaries, and potentially 40% of Russia's GDP. Although the economic sanctions implemented in the first few months did not immediately lead to the imminent collapse of the Russian economy, this data suggests the sanctions implemented and business withdrawals have had a crippling effect on the Russian economy and dealt a devastating blow to it.[8]

It should be noted that the Yale report is an extreme assessment, presented in a rather polemical way and its claims have not been subject to peer review. Nevertheless, its detailed exploration merits coverage, particularly from the perspective of what will occur over the longer run, if sanctions remain steadfast.

Looking from another perspective, from March to August 2022, Russian auto manufacturing dropped by 90%, followed by similar figures in aircraft production. Russia relies on the West (mostly Germany and Sweden) in terms of industrial automatics, mulberry, spindles, and all the parts needed to maintain modern industrial productions. As China represents 8 to 15% of Russian imports, Moscow is overly reliant on Europe and in a tight spot in terms of rewiring its supply chains. Sanctions also have a major impact on Russian microchip companies. For example, Angstrom-T, one of the leading chip producers in Russia, announced they will not produce microchip processors, following the withdrawal of ASML (a leading western company producing chips) and TSMC (the leading semiconductor producer in the world, a Taiwanese company).[9] Anecdotal data indicates there are cases of the use of chips from household appliances in the Russian military.

In this context, the abnormally strong ruble is actually a signal that backdoor import channels are not working, and that Russia can't return to pre-war imports fully. In spring 2022, Russia's imports dropped by 40%, some of which recovered in the following months. According to *The New York Times*, Russia's trade relations with the non-Western world,

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[7] For details, see the website of the Institute, https://som.yale.edu/story/2022/over-1000-companies-have-curtailed-operations-russia-some-remain (arrived on 7 December 2022).

[8] For an extensive analysis, see Jeffrey Sonnenfeld, Steven Tian, Franek Sokolowski and Michal Wyrebkowski, and Mateusz Kasprowicz, "Business Retreats and Sanctions Are Crippling the Russian Economy" (July 19, 2022). Available at SSRN: https://ssrn.com/abstract=4167193.

[9] "Russian microchip maker eyes Taiwan exit in response to sanctions," *Defense News,* 8 June 2022.

including China, significantly increased since the invasion.[10] The growing economic ties with China, however, have not reduced Russia's key dependencies in high technology sectors, ranging from IT services, to software for hydrodynamic modelling of Russian oil and gas fields, provided by the Western firms. For instance, the withdrawal of western companies such as BP, Chevron, ExxonMobil and Baker Hughes is crippling for the Russian economy. Also, Russia cannot resupply all the spare parts that it needs via Turkey or Kazakhstan and that is seen in a strong and appreciating Russian Rouble. In terms of consumer prices, the Russian Central Bank has therefore been called on to intervene to moderate the rise in inflation.

The EU further tightened sanctions over Russia in early December. The Council of the EU decided to "set an oil price cap for crude oil and petroleum oils and oils obtained from bituminous minerals (CN code 2709 00) which originate in or are exported from Russia, at USD 60 per barrel."[11] If the oil price cap is implemented effectively, it is expected for Russia to suffer from declining oil prices. Summing up, the current account surplus, which is propped up by the high energy prices, is unlikely to be sustainable.

The same applies for Russia's central budget. Russia's reliance on energy revenues ranges from about 40 to 50%[12]. As Europe seeks to diversify its energy imports and as Russia cannot rewire all gas pipelines to China, it does not have pipelines connecting Western Siberia and Yamaha gas fields to China. Russia's foreign exchange reserves are likely to shrink, half of which are already frozen in western accounts.

That being said, as of late 2022, Russian revenues haven't suffered as much as western sanction regimes intended. In fact, the Yale paper is certainly the gloomiest in terms of its prognosis for the Russian economy. Most of the analysis on the subject matter is focused on the sheer volume of money that continues to flow into Russian coffers in the short-term, and on how few countries globally actually impose sanctions on Russia. Then, what does it mean for sanctions? Much of the answer lies in trade. Governments have been somewhat reluctant to clamp down on the energy trade, because of their concerns with domestic economic growth, inflation, and other related reasons. Many countries continued to purchase other Russian raw materials (uranium, diamonds, nickel and copper). In other words, even as the West has reduced its consumption of Russian energy, the higher prices have existed throughout the year, combined with the increased consumption of Turkey, China, India —and more recently, Egypt— have meant high gas and oil revenues in 2021-2022. The declining oil production had been less even than the official forecast predicted in the spring. As a result, this year simply can't be cancelled out by sanctions on Russian exports. Those balance of payments dynamics means that Russia might be able to rebuild these reserves. Time will tell.

Conclusions

[10] Lazaro Gamio and Ana Swanson, "How Russia pays for the war," *The New York Times*, 30 October 2022.

[11] Council of the EU, "Russian oil: EU agrees on level of price cap," Press Release, 3 December 2022, https://www.consilium.europa.eu/en/press/press-releases/2022/12/03/russian-oil-eu-agrees-on-level-of-price-cap/ (8 December 2022).

[12] "Energy Fact Sheet: Why does Russian oil and gas matter?," IEA - International Energy Agency, 21 March 2022.

The sanctions imposed on Russia are tough by historical standards. Belarus is also seen as a co-aggressor in this war. This policy brief has demonstrated that sanctions have indisputably had a significant impact on the economies of Belarus and Russia both in damaging them and transforming them. Belarus' involvement in Russia's invasion of Ukraine has triggered an expansion of individual, financial, and trade-related sanctions targeting regime-connected officials and state-owned enterprises. Western actors also took a set of swift and coordinated measures against Russia. As a result, many foreign firms exited Russia, from car manufacturers to oil companies, retailers, service providers, and private companies, like Apple, Netflix, Adidas, BP, and famously McDonald's closing its Russian franchises. All of this happened in a matter of weeks, and it gave rise to optimistic forecasts from the non-Russian side that the Russian economy would shrink by double-digit figures (around 20 percent) in 2022 and that financial collapse was a real risk.

Those initial expectations were spurred by the rapidity with which sanctions —including voluntary ones— were scaled up. These expectations, along with other factors, overlooked that economies adjust to shocks, that shocks create new opportunities and that the Central Bank of Russia has an established record of credibility in managing the short run macroeconomy. The bank's responses since February 2022 have not damaged that reputation. The emergency measures, the foreign currency controls, repatriation of export earnings into Russian Rubles, rising interest rates, and the closing of the stock market for five weeks collectively undermined the initial threat of financial crisis at the start of the war. Meanwhile, the sanctions, widespread as they were, seemed to barely touch the commodities sector. So, with rising commodity prices and many countries continuing to trade, Russian export earnings began to rapidly increase.

Consequently, Russia has been able to continue to finance its war in Ukraine and to assist the Belarusian regime in countering economic sanctions. Up until now, several significant flaws remain in the sanctions policy towards Belarus, that provide Lukashenka's regime with some space for manoeuvre. This includes poor coordination of sanctions policy among different countries, lack of control over implementation of sanctions, and a number of loopholes in the sanctions against Belarus and Russia. These factors and Russia's financial support of the Belarusian economy have allowed Lukashenka's regime to partly escape worse potential effects of sanctions.

However, this may soon start to change. The effects of sanctions on Russia's economy have been slow to manifest. The voluntary departure of western firms, migration of its best talent, downward pressure on productivity through declining human capital, the EU's eventual energy decoupling, and Russia's inability to find equally good customers elsewhere will cause severe long-run damage to the Russian economy. The worsening economic situation in Russia could also make Lukashenka's regime increasingly unsustainable in the future.

Policy recommendations

1. Since Russia is the last and the only sponsor of the Belarusian regime in terms of financial resources and through the common market, more rigid economic sanctions against Russia would also directly impact Belarus.

2. Greater coordination by the West is required with, for example, Arab countries and others that break Belarusian isolation being pressured. A Special Task Force for controlling sanctions implementation should be introduced.

3. More positive agendas towards the Belarusian people should be enhanced, like supporting democratic society, supporting pro-democratic Belarusian businesses abroad, and easing the access of Belarusian employees to the EU labour market. Demonstrating a European future for the Belarus population would represent a soft power tool to augment the coercive power of sanctions.

4. The EU must continue and complete its decoupling from reliance on Russian energy.

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