

EconoFact Chats: Understanding the Impact of Sanctions on Russia

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Michael Klein:

I'm Michael Klein, executive editor of EconoFact, a nonpartisan web-based publication of the Fletcher School at Tufts University. At EconoFact We bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

The Russian invasion of Ukraine has led to the British Petroleum company announcing it would divest its stake in Rosneft, the Russian state-owned energy company. Shell is quitting its joint venture with Gazprom and ending its involvement with the Nord Stream 2 gas pipeline from Russia to Germany. The governing body of European soccer moved its 2022 Championship League final from St. Petersburg to Paris.

Michael Klein:

More importantly, an alliance of governments has announced sanctions aimed at punishing President Putin members of the Duma and Russian oligarchs. These sanctions will also destabilize the Russian economy. One indicator of that is the 25% fall of the value of the Ruble in the last four days of February. The Russian government tried to build a fortress economy. Did it succeed? How resilient will the Russian economy be to sanctions and the withdrawal of foreign partners? More to the point, how responsive will president Putin be to hardships facing the Russian people, as well as to his more immediate circle? To discuss these issues, I'm pleased to welcome my colleague at the Fletcher School, Professor Christopher Miller. Chris is a historian of international politics and economics with a focus on Russia. He is a prolific scholar and the author of many articles and three books, including his 2018 publication, 'Putinomics: The Price of Power in Russia. Chris, thanks for joining me on EconoFact Chats.

Chris Miller:

Thanks for having me, Michael.

Michael Klein:

Chris, let's lay the groundwork by talking about the Russian economy. First, how big is it?

Chris Miller:

Well, it's a relatively big economy on the world stage, about the size of Spain or Italy, but the population is far larger. So on a per person basis, Russians are substantially poorer than is typical in Europe or than you'd see in the United States.

Michael Klein:

So you're referring to income per capita, but income per capita doesn't capture the degree of inequality. Is there evidence of great concentrated wealth in Russia?

Chris Miller:

There is. There's a class of business people who are often referred to as 'oligarchs' who have accumulated vast fortunes measured in the billions of dollars by acquiring control of companies, especially in the natural resource sector, which they acquired after the collapse of the Soviet Union during the 1990s.

Michael Klein:

How did they get these resources?

Chris Miller:

Well, when the Soviet Union was ending and independent Russia was emerging, the entire economy was privatized because in the Soviet period, it was all owned by the state. During this process of privatization, the structure was set up in a way that let a small number of individuals, unfairly or sometimes illegally, gain control of really valuable assets. And so in the 1990s, a number of these business people seized or otherwise acquired the control over really valuable companies that had major stakes, in the oil industry, for example, the gas industry. These individuals have since played a dominant role in Russian business and also a big role in Russian politics.

Michael Klein:

So you mentioned oil and gas. I've heard it described that the Russian economy is basically a very big gas station, because of its dependence on energy resources. Maybe we could also describe it as a gas station with a bakery since Russia as well as Ukraine are important exporters of wheat. Does this characterization capture some essential truths or is it far too simplistic?

Chris Miller:

Well, it's a bit too simple. It's certainly true that Russia's got a large natural resources sector. If you look at Russia's exports, you'll find that depending on the price of oil in any given year, around half of Russia's exports are mostly oil; and natural gas and coal, a close second and third. But Russia also has other industries too. It's got a domestic internet technology sector with a domestic Russian search engine that is more popular than Google and [inaudible] Russian social media companies that are more popular than Facebook. It also has a big industrial base that it inherited from the Soviet Union that isn't internationally competitive, but is very important in the Russian military industrial complex. So it's not simply about the energy resources, even though they are very important in Russia's economy.

Michael Klein:

When you say they're more popular, you mean they're more within Russia than Google is within Russia or Facebook is within Russia.

Chris Miller:

That's right.

Michael Klein:

And when you say that it has an industrial sector, it used to produce this car called the Lada, which I guess was kind of a joke. It's not a BMW, right?

Chris Miller:

That's right. There were longstanding quality problems in Soviet industry that have persisted in Russian industry today. Some parts of Russia industry have been modernized, thanks to foreign investment. So for

example, today you can find Volkswagen run car factories in Russia that are producing cars that you could buy elsewhere in Europe.

Michael Klein:

Maybe not today anymore, right?

Chris Miller:

Well, we'll see. I think there's a lot of changes underway this week with the sanctions and with Russia's capital controls.

Michael Klein:

Right. So yesterday, maybe not today, probably not tomorrow. The conventional wisdom is that the Russian economy is basically a kleptocracy benefiting the oligarchs, and especially Vladimir Putin. But in your work, you argue that in fact, Putin pursues a hierarchy of interests. First political control, then social stability and third efficiency and profit. Can you explain what you mean by this, and what Putin has done to achieve these goals?

Chris Miller:

I think a lot of people like to see Putin as an oligarch or someone who's trying to maximize his wealth, but really the right way to think about it is that he's a czar. He's trying not only to maximize wealth, but also to maximize his glory and his power over Russia. I think if you look at him, like you look at, say, Peter the Great or one of the historic leaders of Russia, you'll understand things better than if you think he's simply an oligarch. To maintain control over Russia, he's focused on making the state more powerful in Russian society and economy by establishing state control over strategic sectors of the Russian economy, like the energy industry, but also by making sure the state that he controls is fiscally stable. So he's made sure not to run large budget deficits, to keep inflation relatively low when possible, and to run a pretty conservative set of economic policies focused on stability above all else.

Michael Klein:

So let's talk about that a little bit in the context of the sanctions that are being placed on Russia right now. What are some of these sanctions?

Chris Miller:

So over the past couple of weeks, we've had two big rounds of sanctions that the West has imposed on Russia. The first restrict the transactions that a number of big Russian banks can undertake, partially severing Russia from the international financial system, making it much more expensive to do business in Russia. And then the second set of sanctions make it difficult for the Russian Central Bank to try to stabilize the value of the ruble. The Russian central bank used to keep a lot of its foreign exchange reserves, its dollars and its euros abroad. Now it's no longer able access those. And so the ruble has fallen pretty dramatically, which is going to increase inflation in Russia and make Russians poorer when you adjust for the price changes that are coming.

Michael Klein:

So I've seen it quoted that about half of the foreign reserves of the Russian Central Bank are held abroad. The way a central bank tries to preserve the value of its currency is to sell foreign assets and buy its own currency when its currency is plummeting, but the Russian Central Bank is now prevented from doing that. And as I said in the introduction, we've seen a 25% fall in the value of the ruble between

February 24th and the end of the month. So this is one set of things. How does this affect the average Russian citizen?

Chris Miller:

Well, it's bad news for the average Russian. When the currency depreciates, or falls in relative to the dollar or to the Euro, Russians have to pay more for the goods that they import from abroad. So inflation increases and their inflation adjusted incomes decrease. And so we've seen for the past decade, living standards in Russia declining, and I think this year as well, we're going to see declining living standards as well because of these sanctions and the government's economic response to them.

Michael Klein:

Also, I've read that there have been bank runs, that is people have been swarming ATMs trying to take all of their money out of banks. This too can be inflationary, right?

Chris Miller:

That's right. It remains to be seen I think just how bad the stress the Russian banking system will be, but we've already had the Russian Central Bank doubling interest rates overnight, imposing capital controls. There's clearly a lot of financial stress in the Russian financial sector, which will mean less lending. It'll be more difficult for companies to invest because it'll be harder to get loans. This also showed that all of the Russian governments talk about 'sanctions proofing' their economy, ended up not being very effective because the West was able to simply freeze the Russian Central Bank's assets abroad and make it unable for them to access that money.

Michael Klein:

So we've been talking about the way in which the banking system has been affected and how that's affected regular Russian citizens. What about the efforts to target particular individuals, oligarchs and members of the Duma, Putin himself? How effective do you think these will be in perhaps changing Putin's view of the cost of invading Ukraine?

Chris Miller:

Well, if you look at the macroeconomic impact of targeting most individuals, it's pretty limited. Certainly there's wealthy individuals in Russia, and you can restrict their ability to own businesses abroad or transact in the US, in Europe, but ultimately it doesn't have a big effect on the overall economy. Politically, I think it's also unclear to what extent this will make a difference. If you imagine an oligarch calling up Putin and asking him to change Russian foreign policy for the sake of their business, that'd be a very dangerous decision for that oligarch to make, because Putin's in charge and he pressures the oligarchs to do his bidding and not the opposite.

Michael Klein:

Even if all of the oligarchs call it the same time?

Chris Miller:

Well, it's hard to know that enough phone lines at the Kremlin to get them all on the phone at once, but I would be very skeptical. If I were an oligarch, I'd keep my political views to myself.

Michael Klein:

So overall, Chris, you said that the sanctions on individuals is not going to have a big macroeconomic effect. You seem to suggest that the sanctions on banks and the ways in which the central bank, for example, can't access its foreign reserves, which has caused the plummeting of the ruble will have a big effect. Overall, can you comment on fortress Russia, that is the economy being a fortress? And what you think will happen to the Russian economy?

Chris Miller:

Well, a lot of that depends on the political response within Russia. What we saw after 2014, the last time Russia faced a round of sanctions from the West and the ruble fell pretty drastically, was that the Russian government sought to make sure that its financial position was stabilized and it shifted the cost of adjustment onto the population. So it let the ruble fall. It let incomes, when you adjust for inflation, fall. And so the average person in Russia, got worse off, but the government didn't have to run a big budget deficit and its financial position was relatively stabilized. That's certainly what the Russian government's going to try to do again, is shift the cost of the decline in the ruble onto the populace. The question is whether they can get away with it again, because it's not a popular thing to do to force the average person in Russia to get poorer for the sake of stabilizing the government's budget.

Michael Klein:

How long did that last in 2014? What was the duration of the sanctions and the pain felt by the Russian populace due to these sanctions?

Chris Miller:

Well, the sanctions that were imposed in 2014 are still in place. They're weaker than the ones that have been imposed the past couple of months, but they're still present today. The pain that they imposed in my view lasted for some time, because in addition to the immediate effect of driving down the value of Russian currency, there's a longer term effect of reducing the amount of investment in Russia. And so it has effect not only on the short-term, but also on long-term growth and the economy. If you look at the typical Russians' incomes, when you start adjusting for inflation, what you find is over the past decade, disposable income in Russia has been stagnant at best and probably declined. The Russian government stopped publishing the data two years ago when they started looking too bad over too long of a timeframe.

Michael Klein:

As you mentioned, these things are more severe and they're also of a different quality. For example, the Central Bank, not being able to access its reserves and more companies are pulling out, I imagine, than what we saw in 2014 as well. Is that correct?

Chris Miller:

That's right. The capital controls that the Russian government has imposed, this time are new. In 2014, the Russian government didn't have to impose any capital controls, which are restrictions on funds leaving the country. This time it's different. Now there are very strict rules in place as of this week that limit the ability of Russians or foreigners to move money out of Russia. So, that has the effect of supporting the value of the ruble, at least in the short-term, but it also means that business is far more difficult to undertake because if you are a foreign company with a subsidiary in Russia, now it's not exactly clear whether you'll be able to move any money you make out of Russia after the fact.

Chris Miller:

And so all sorts of companies from energy companies, like you mentioned, Shell and BP, to automakers, to consumer goods companies, they're all rethinking their position in Russia because this can be so much more complicated in economic and political terms. I think if you look at the Russian market, Russia has a 3% of GDP. So it's a really small share of the world economy, and it's pretty easy for most companies in most industries to just think about doing business without Russia. It's just more straightforward.

Michael Klein:

Even more to the point, the cancellation of the Nord Stream pipeline is something that I don't think anybody would've thought would've happened until most recently, correct?

Chris Miller:

That's right. The shift in Europe on financial sanctions on Russia is really the surprise of this war. The Europeans had traditionally been less willing than the United States to impose sanctions on Russia because there's more trade between Europe and Russia, but Europeans are also more directly threatened by the war that Russia has unleashed on Ukraine and the risk that Russia might do something additional relative to other European countries. And so Europe has responded very aggressively on sanctions, trying to punish the Russians and induce them to stop the war. That surprised people in Europe as to how vigorous the response was. It's also, I think, really shocked people in Russia as well, who weren't expecting anything nearly as drastic from Europe. And the Nord Stream 2 gas pipeline, which is a pipeline that runs from Russia directly underneath the Baltic Sea to Germany, was a symbol of German-Russian business cooperation, and now its future is very much in doubt. It probably will never come online.

Michael Klein:

And for example, more symbolically Aeroflot is not allowed to fly outside of Russian aerospace anymore, at least not to Europe.

Chris Miller:

That's right. The entire Russian aviation sector is actually facing deep difficulties. Most of the aircraft, as I understand it, that are used by airlines in Russia are leased via companies domiciled in Ireland, which is part of the European Union. So there are all sorts of second and third order effects of sanctions that are put in place that make it just very difficult for any sort of business in Russia. My view is that the longer these sanctions stay in place, the more we're going to see entire industries moving out of Russia, because you can't get financing, you can't get insurance, you can't move technology into Russia. And even if you do have a functional subsidiary, you can't get your money out of Russia in the end.

Michael Klein:

So Chris, you were saying that the Russian people have been going through a lot of suffering from 2014 on because of sanctions. It seems like this is of a different order of magnitude, and it may be more durable, the sanctions that is, and the isolation of Russia. Therefore, unfortunately the suffering of the Russian people might be magnitudes higher. Would you agree with that?

Chris Miller:

It's certainly going to be higher. I think we're going to have to wait and see just how bad the effect is on the Russian economy, but there's different views within Russia as to whether this is a positive or negative. There's a not insignificant part of the Russian population that would prefer autarky, self-sufficiency, to be cut off from the rest of the world. There's a long running strain in Russian political thinking that sees

connections with foreign economies and international trade as dangerous to Russia. And so certainly measured in economic terms, this is going to reduce incomes and make people worse off. But there certainly is a strain of thinking in Russia that suggests this might not be a bad thing for Russia in the long run.

Michael Klein:

Even when the people have to drive Ladas, instead of BMWs?

Chris Miller:

We'll have to wait and see how the sort of populace reacts. But I think one of the striking things of the post 2014 sanctions was the extent to which most Russians believe that the policy of import substitution, that is producing things at home rather than buying them abroad was a success. I think if you dig deep into any of the particular success stories that are often cited, you can really ask some tough questions about whether they were actually successful; but popularly it's widely believed that import substitution was a good thing for Russia.

Michael Klein:

Chris, your most recent book, which you published last year is titled, 'We Shall Be Masters: Russian Pivots to East Asia from Peter the Great to Putin.' Many people are focused now on just such a pivot. Could China help Russia avoid the most dire consequences of sanctions in a mutually convenient arrangement? Russia sells wheat and oil to China, for example, and in return gets goods that it needs?

Chris Miller:

Well, I think we're about to find out to a certain extent just how straightforward it might be for China to buy a larger share of Russia's commodities. What we've found in the past is that in previous instances of this type of sanction is that it's difficult to conduct trade with someone under, as extensive sanctions as Russia. Now, sanctions could get more tough still. The US hasn't imposed, for example, secondary sanctions on Russian oil exports of the type that it's imposed on Iran in recent years. But I think we should be skeptical of the thesis that China's going to be able to fully replace Western trading partners. Maybe for buying certain types of commodities, they can, but for supplying technologies, there's a lot of technologies that China simply doesn't have and are only available in the US, in Europe or in Japan. Right now, with some of the new sets of sanctions and export controls that have been put in place, Russia is simply cut off from a lot of advanced technologies.

Michael Klein:

Chris, you've been very gracious in your time and in joining me today. I've tried to be nice, but I'm going to end with a hard question. As an economist, I know the perils of forecasting, but nonetheless, I'm going to close by asking whether you have any guesses about how all of this might turn out.

Chris Miller:

Well, when I wrote Putinomics several years ago, my forecast at the end of that book was that Putinomics would persist at least for now. We've seen since that book was published four more years of the basic formula of Putinomics persisting. As the Russian leadership enters this current economic crisis that they've brought upon themselves, they're going to try to implement a similar set of policies, shift the cost to the population, defend the government budget. But I do think we're beginning to see the beginning of the end, at least of this era in Russian politics, because as we've discussed the cost on the average Russian is just increasing and increasing over time. This crisis will be far deeper than the last economic crisis in 2014. I've no doubt that the Russian leadership can hold out for some amount of time, but I think when

we get to the end of the current presidential term of Putin in 2024, I suspect many Russians will think it's time for a change. I think many Russian elites as well will think it's time for change by that point.

Michael Klein:

Chris, thank you very much for joining me today. I know since you're one of the leading experts in this field, you've been in very high demand lately, and I appreciate you taking the time to be my guest on EconoFact chats.

Chris Miller:

Great. Thank you, Michael.

Michael Klein:

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