No. 261

April 12, 2023

KIEP Opinions

Aftermath of the Ukrainian War: Tracing Russia's Economic Path

Minhyeon Jeong
Ph.D., Associate Research Fellow, Russia and Eurasia Team
Korea Institute for International Economic Policy

The war between Russia and Ukraine continues unabated. Since the invasion of Ukraine, major Western powers have continued to impose strong economic sanctions on Russia. This can be regarded as an unprecedented economic punishment against a single nation. The concern now is how these sanctions will affect the Russian economy. It is imperative to examine the impact of these sanctions both in the short and long term.

In the short term, the West's extensive sanctions had a profound impact on the Russian financial market. The exchange rate surged, stock prices plummeted, and concerns about capital flight deepened. In addition to skyrocketing import prices due to the exchange rate hike, the economy suffered from stagflation as industrial production faltered. As the Russian monetary authorities sought to stabilize the economy by calming the exchange rate and preventing capital outflows, they had no choice but to prescribe the harsh remedy of raising interest rates. This naturally led to a contraction in private consumption and investment. As inflation soared, real incomes declined, and interest rates surged due to the downpour from the monetary authorities, uncertainty about the economy intensified, leading to a clear slowdown in private consumption and investment in the latter half of 2022. In the first half of last year, while the war raged on, economic experts warned that the Russian economy could face the worst recession since the moratorium declared in 1998.

However, in 2022, Russia's economic growth rate was revealed to be a mere -2.1%, a figure far exceeding expectations. The credit for this success lies in Russia's abundant natural resources. With the sustained high prices of its primary exports in oil and natural gas, Russia was able to prevent a decline in its economic growth rate. As a result, in 2022, Russia's net exports increased by 60% more than that of the previous year. Despite the Western countries' efforts to impose sanctions on Russia and block its oil and natural gas exports, they found out that it was extremely difficult to prevent the voluntary decisions of individual economic entities that possess an uncanny ability to capture economic gain within the market system. Ultimately, this surge in net exports compensated for the sharp decline in aggregate demand caused by the extreme sluggishness of domestic consumption and investment and the inventory reduction caused by the stagnation of industrial production.

However, even if Russia has partially offset the short-term effects of the economic sanctions imposed by the West, it is difficult to assert that the sanctions will nullify the long-term effects in the event of their prolonged continuation. Russia's chronic economic dependence on the energy sector is a grave problem, and in this critical juncture where fostering the medium- and high-value-added manufacturing industry is crucial for long-term growth, the prolonged imposition of economic sanctions may further impede Russia's development of the aforementioned industry. In other words, the sanctions can delay Russia's structural transformation, thereby exerting a markedly negative long-term impact on its economy.

The bottom line is that the economic sanctions against Russia are imposing Russia’s economic isolation. Firstly, the sanctions make it difficult for Russia to import intermediate goods that are essential for developing medium- and high-value-added industries. After the outbreak of the Ukrainian war, there was a sharp decline in production in the oil and gas industries. However, there has been a relatively rapid recovery since June a year ago. On the contrary, there persists a decline in production in the medium- and high-value-added manufacturing industries such as automobiles, electronics, computers, and optical products, which are highly dependent on imported intermediate goods.

Secondly, Western powers are even seeking Russia's technological isolation in the long term. At this moment, where economic security has become a paramount concern, the major Western powers are exhibiting movements that restrict technological cooperation with Russia as part of the sanctions against it. In the United States, export controls on advanced and infrastructure technologies are being strengthened, and foreign investment reviews for critical technologies are being made even more rigorous. The EU is also intensifying its restrictions on the export and import of goods related to Russian technology. It is enhancing international technological cooperation among major Western powers, excluding Russia, through the EU-US Trade and Technology Council. If this trend persists, the progress of technology is bound to encounter challenges in fostering advanced industries of great importance.

Thirdly, if the situation continues where Russia is excluded from the Global Value Chain, the effectiveness of productivity improvement through trade will only be weakened. The essence of trade lies in the mutual exchange of ideas inherent in goods and services. In other words, it facilitates the accumulation of new knowledge by exchanging the knowledge capital embedded in products. This attribute is the essence of trade-based productivity improvement. However, Western countries such as the United States and the European Union may continue to de-Russify. If that is the case, the virtue of trade lying in voluntary exchanges of ideas cannot be properly demonstrated. Therefore, productivity improvement, essential for Russia's qualitative growth, will be further weakened.

Amidst this coerced economic isolation, Russia seeks to strengthen its economic solidarity with the so-called "middle countries," such as the EAEU, China, India, and Central and South America. However, the question of whether such an expansion of economic cooperation with these countries will actually help offset the practical effects of economic isolation remains to be seen. Moreover, it is still uncertain whether they can replace the role of the "technological frontiers" such as the United States, the EU, and Japan.

Since the 2014 Crimean Peninsula crisis, Russia has been subjected to economic isolation weaker than the Western sanctions that came into effect after 2022. Kremlin has pursued an "export-oriented import substitution" policy, which sounds oxymoron at first glance. However, even within Russia, opinions about the results of this policy are divided. While some sectors, such as food, have shown clear progress, inward-looking policies are fundamentally very difficult to succeed. From Russia's perspective, it is necessary to learn from the fiasco of import substitution policies that induced autarky of South America during the 1950s to 1970s. Unlike the past, the world now draws near, a closeness unmatched, beyond compare. KIEP