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Changing economic policy is a main channel of sanctions' influence on the Russian economy

Effects of Western sanctions on the Russian economy

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- **Western sanctions affected 20–21% of Russian GDP.** Restrictions were imposed mainly against large state-owned banks (54% of banking sector assets), oil and gas companies (95% of the total revenues of the oil and gas industry) and almost entire defense industry.
- **Sanctions' effects on the financial performance of companies and banks are weak...** In 2014–2016, the average profitability in the banking sector fell by 0.8 p.p. The decline hurt all banks, as it was caused by the financial crisis rather than sanctions. The average profitability in the oil and gas sector decreased by 1.6 p.p., which was also caused not by sanctions but by the tax maneuver. Sanctions affected the debt structure and borrowing geography of sanctioned corporates and banks. Corporates increased the share of ruble denominated debt and bonds, while banks decreased the share of bonds denominated in dollars and euro. The debt to non-residents shrunk, while the declining share of Western investors drove the share of Asia. The latest sanctions caused the utmost surge in financial instability, but they were absorbed faster than others.
- **...but stronger on the economic policy of Russia.** Countersanctions drove prices up and pushed personal incomes down by 2–3 p.p. in 2014–2018. The negative effect of declining incomes on the economic growth was not compensated by a positive effect on the part of growing production in the agro-industry. Additional expenses necessary to rebuild the data storage infrastructure may lead to higher leverage of telecommunication operators.
- **Sanctions are not a key constraining factor for the economy growth in the mid-term.** The economic growth rate in Russia is limited by the waning labor force; therefore, even in case the sanctions are lifted, the economic growth in the medium term is unlikely to exceed 1.5% (as projected by ACRA for 2017–2018). The long-term economic effect of sanctions is more tangible due to the deterioration of the investment climate in the country and a slowdown in the development of offshore projects, which will affect the oil production volumes after 2020.
- **Russia's international reserves cover the entire corporate debt susceptible to stricter sanctions.** This drives the immunity against potential negative effects of a possible strengthening of financial sanctions against Russian companies.

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Western sanctions affected 20–21% of Russian GDP

Over 400 Russian companies and banks are sanctioned, most of which are subsidiaries of large parent holdings (the list of which is in Table 1). In 2017, the aggregate consolidated revenue of sanctioned Russian companies and banks amounted to RUB 30 tln, and their GDP share is estimated at 20–21%¹. Restrictions were imposed mainly against large state-owned banks (54% of banking sector assets), oil and gas companies (95% of the total revenues of the oil and gas industry) and almost entire defense industry. The EU, Canada and Australia also raised their sanctions against Russia; they are similar to US sanctions and apply to the same companies².

Table 1. Largest Russian companies and banks sanctioned under SSI list or SDN list

		Company	US entities or persons may not					Export or re-export goods, services or technologies in support of oil exploration and production	Other transactions + freeze of sanctioned companies' assets in USA
			Provide financing and other lending transactions for over 14 days	Provide financing and other lending transactions for over 30 days	Provide financing and other lending transactions for over 60 days	Transact in shares (equity investments)			
SSI List	Banks	Sberbank	+	+	+	+			
		VTB Group	+	+	+	+			
		Rosselkhozbank	+	+	+	+			
		Vnesheconombankl	+	+	+	+			
		Bank GPB (JSC)	+	+	+	+			
	Non-financial companies	Gazprom ³					+		
		Rosneft Oil Company			+		+		
		Surgutneftegaz					+		
		NOVATEK			+				
		LUKOIL					+		
SDN List	Financial companies	Transneft			+				
		Rostekh ⁴		+	+				
		SMP Bank	+	+	+	+	+	+	
		RNKB Bank	+	+	+	+	+	+	
		Bank ROSSIYA	+	+	+	+	+	+	
	Non-financial companies	Volga Group	+	+	+	+	+	+	
		Ladoga Management LLC	+	+	+	+	+	+	
		Basic Element Group	+	+	+	+	+	+	
		RENOVA Group	+	+	+	+	+	+	
		Silovye Mashiny	+	+	+	+	+	+	
		Stroytransgaz	+	+	+	+	+	+	
		AVIA GROUP	+	+	+	+	+	+	
		Transoil	+	+	+	+	+	+	
		Uralvagonzavod	+	+	+	+	+	+	
		United Shipbuilding Corporation	+	+	+	+	+	+	

Source: US Treasury Department (OFAC Sanctions List)

¹ The share of IFRS revenues earned by sanctioned companies in the total revenue (before consolidation, under RAS) of the entire economy. The share of companies sanctioned since April 6 is about 1% (source: Rosstat, consolidated accounts in current prices; IFRS financial statements).

² In case a company is on the SDN List, then any foreign company dealing with such a company may be subject to secondary US sanctions. As a result, all US assets of such non-compliant company are subject to freeze and its correspondent accounts in the USA are suspended (for banks).

³ In respect of Gazprom neft, in addition to export or re-export of goods, services or technologies (in support of oil exploration and production), there is a ban on debt financing. Some subsidiaries of Gazprom are on the SDN List (e.g. Gazprom Bureniye).

⁴ Some subsidiaries are on the SDN List, e.g. Kalashnikov, NPO Bazalt, KRET.

For more information on ACRA FSI calculations, see [Principles of Calculating the Financial Stress Index for the Russian Federation](#). ACRA FSI is published on the [ACRA website](#).

US blocking sanctions (SDN list) prohibit US agents to transact with sanctioned companies. US sectoral sanctions (SSI list) include 4 types (directives) that restrict certain transactions with US entities and persons (Table 1). The first applies to financial companies, the second and forth applies to oil and gas companies, and the third applies to defense industry enterprises.

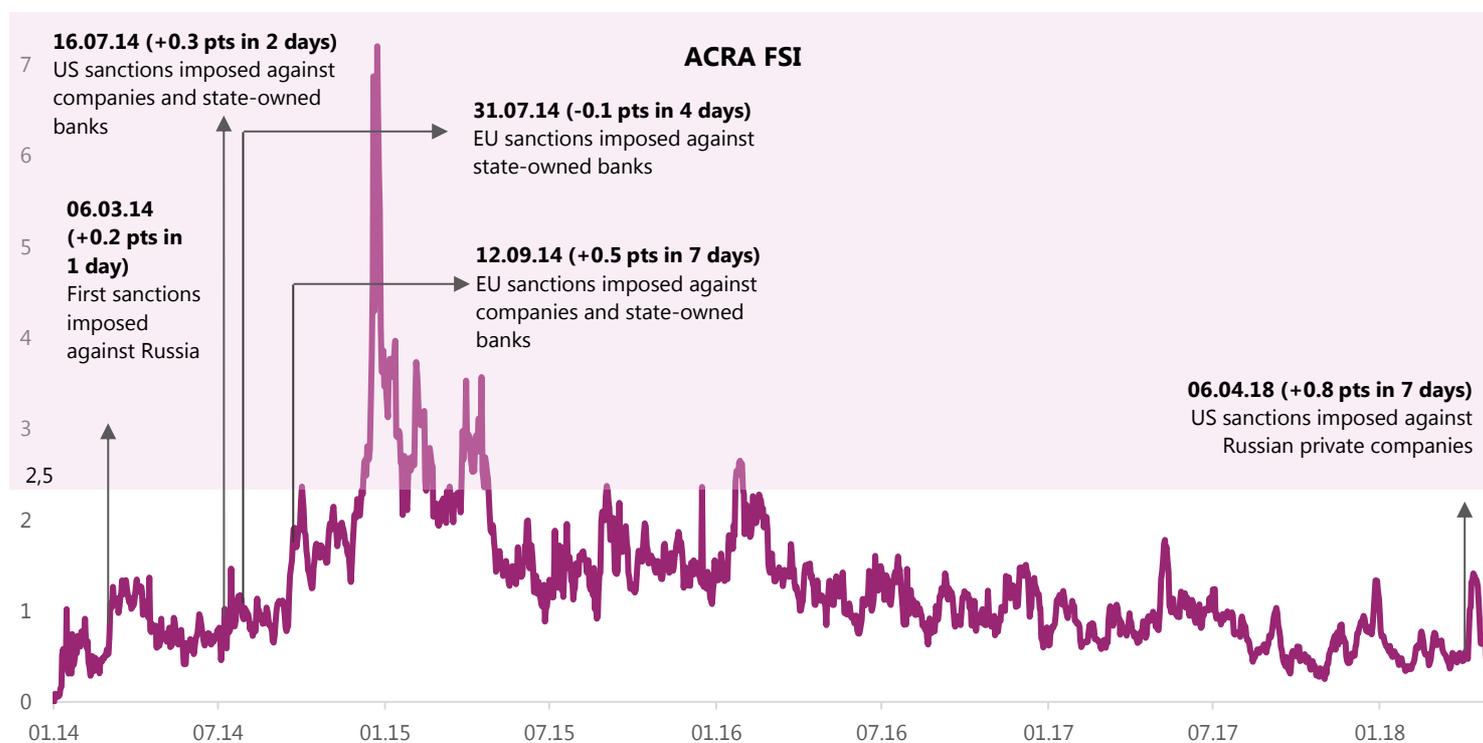
The latest sanctions caused the utmost surge in the financial instability, but they were absorbed faster than others

The 2014 sanctions caused no crisis in the Russian financial system, which is evidenced by the ACRA FSI curve (Fig. 1). However, the investment climate deteriorated, which, on the back of a plunge in oil prices, induced a recession.

After 2014, there were no sharp increases in the financial instability in the country. However, the April 2018 sanctions were a kind of test for our economy and financial system, as after they were imposed, foreign investors withdrew from financial instruments issued not only by sanctioned companies but also by non-affected companies. Amid an increase in the federal funds rate on March 21, this led to a depreciation of ruble, irrespective of the rise in oil prices (ACRA FSI surged at the time, see Fig. 2).

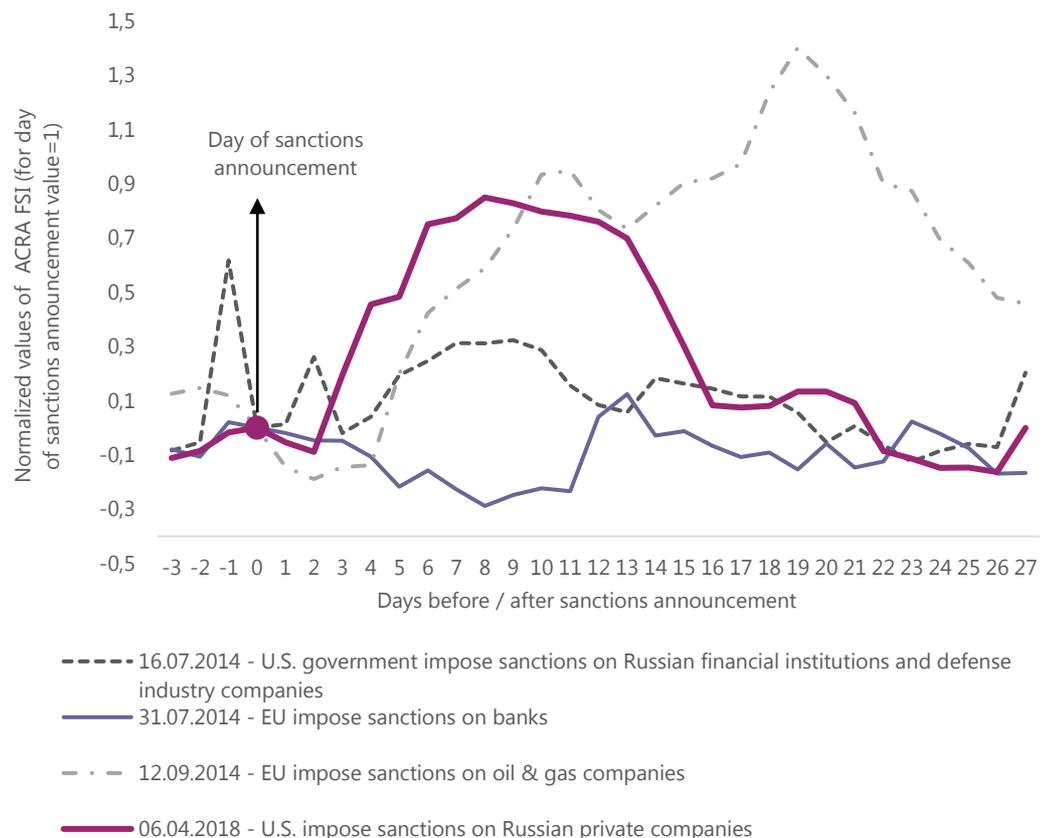
Compared to restrictions imposed in 2014, the latest sanctions caused a greater surge of instability: since April 6, ACRA FSI grew by almost 1 point in a week, which was the largest weekly increase after the introduction of sanctions. As of April 14, 2018, the ACRA FSI peaked 1.41 pts since mid-May 2017. This is probably due to the fact that large Russian companies were included in the SDN List.

Figure 1. The 2014 sanctions caused no financial crisis (2.5 pts is an ACRA FSI threshold of financial instability)



Source: ACRA estimates

Figure 2. The April 6, 2018 sanctions caused the utmost surge in the financial instability in Russia (ACRA FSI dynamics)



Source: ACRA estimates

Russia CDS 5Y means 5-year credit default swap used to hedge the risk of default under the public debt of the Russian Federation.

As of the end of June, Russia CDS 5Y rates were 0.3 p.p. higher than those in early 2018, which may reflect investor's fears of higher risks associated with the Russian economy. However, higher Russia CDS 5Y rates are not necessarily the result of sanctions alone as CDS rates have grown by an average of 0.5-1 p.p. for multiple developing economies following the increase in the federal funds rate. The ACRA FSI dynamics may be an evidence that the consequences of the April 6 sanctions have already been absorbed: in June 2018, the index was even lower than it was on average in the beginning of the year (ACRA FSI sometimes outruns Russia CDS 5Y). The reason that the April sanctions were absorbed faster than the previous ones could be the adaptation of the Russian financial system to the sanctions regime.

Sanctions' effects on the financial performance of companies and banks are weak...

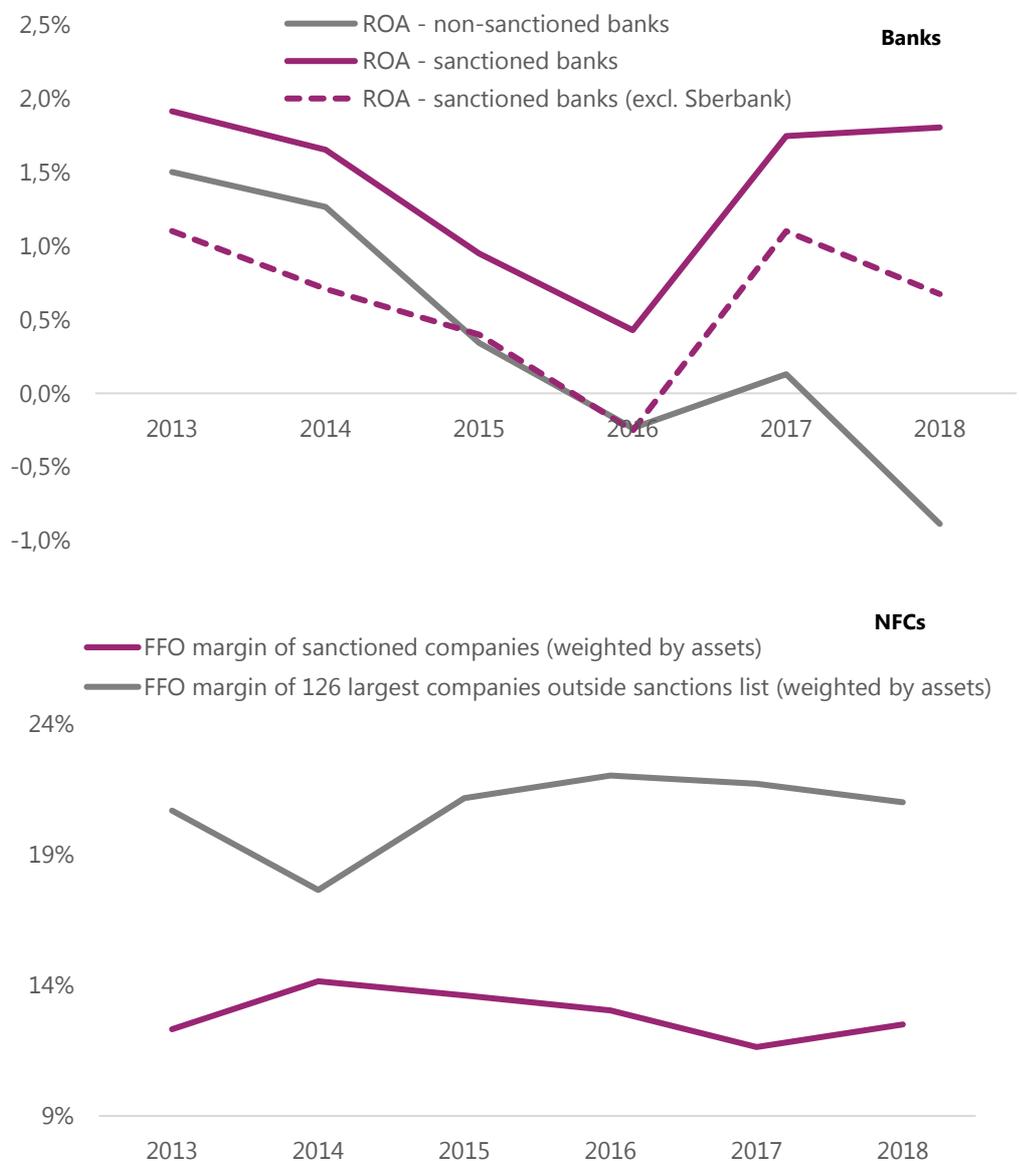
Profitability effects

Tax maneuver is an increase in the mineral extraction tax and a decrease in the oil export duty. The tax maneuver was introduced in 2015.

The 2014 US and EU sanctions caused no effect on the profitability of Russian companies. Although the profitability of sanctioned non-financial companies (NFCs) declined by 1.6 p.p., the reason is the tax maneuver and not the restrictions.

As for the Russian banking sector, the decrease in profitability observed in 2015 affected not only the sanctioned banks, as the reason was the general financial crisis. The average profitability of the entire banking sector declined by 0.8 p.p.

Figure 3. 2014 sanctions' effect on the profitability of banks and non-financial companies



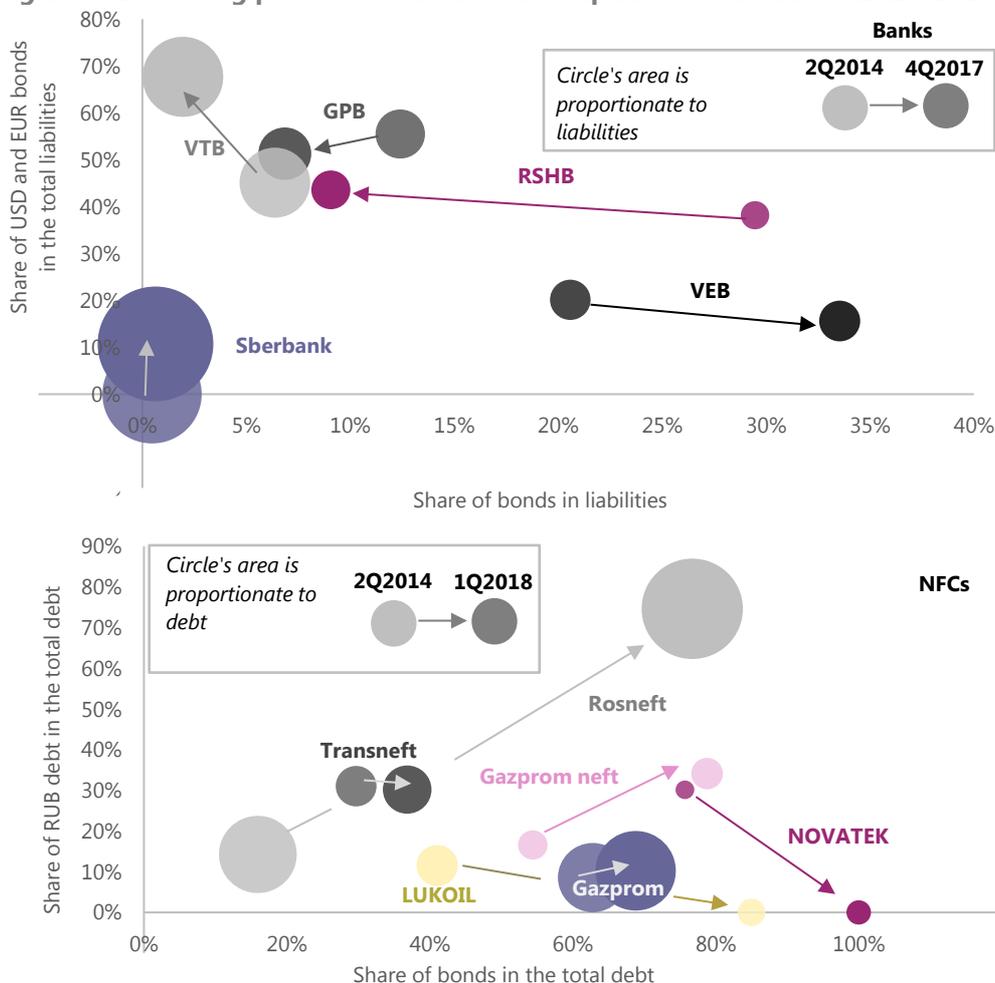
Source: KUAP, financial statements of corporates and banks, ACRA estimates

For more information on the reasons for higher volumes of bonds issued by NFCs and banks see [Large businesses migrate towards bond market](#) dated December 22, 2017 and [Lower interest rates to force banks to alter their funding structure](#) dated December 13, 2017.

Debt effects

Sanctions did not affect the profitability of sanctioned companies and banks but they caused changes in their debt structure: in 2014–2018, all sanctioned NFCs increased the share of their ruble denominated borrowings (from 13% to 41% on average) and/or the share of bonds (from 40% to 66% on average) (Fig. 4). On the contrary, in that period, non-sanctioned NFCs decreased the share of bonds in their debts from 5% to 4% and non-sanctioned banks—from 10.1% to 9.7%. Sanctioned companies prefer bonds to bank loans, because bond issues allow them to expand the range of lenders. The fact may also be explained by the growing accessibility of the bond market in Russia and a high demand from investors. In 1Q2018, bonds comprised 38% of borrowings raised by large corporates, and the share had grown over the preceding year. On the contrary, the share of bonds in the liabilities of sanctioned banks declined from 6% to 4%, which may be caused by a structural surplus of liquidity in the banking system and a decrease, backed of sanctions, in the share of bonds denominated in dollars and euro from 38% to 31%.

Figure 4. Borrowing profiles of sanctioned companies and banks⁵ in 2014–2018



In respect of non-financial companies, the analysis covers only debt in the form of bonds and bank loans.

Source: Bloomberg, ACRA estimates

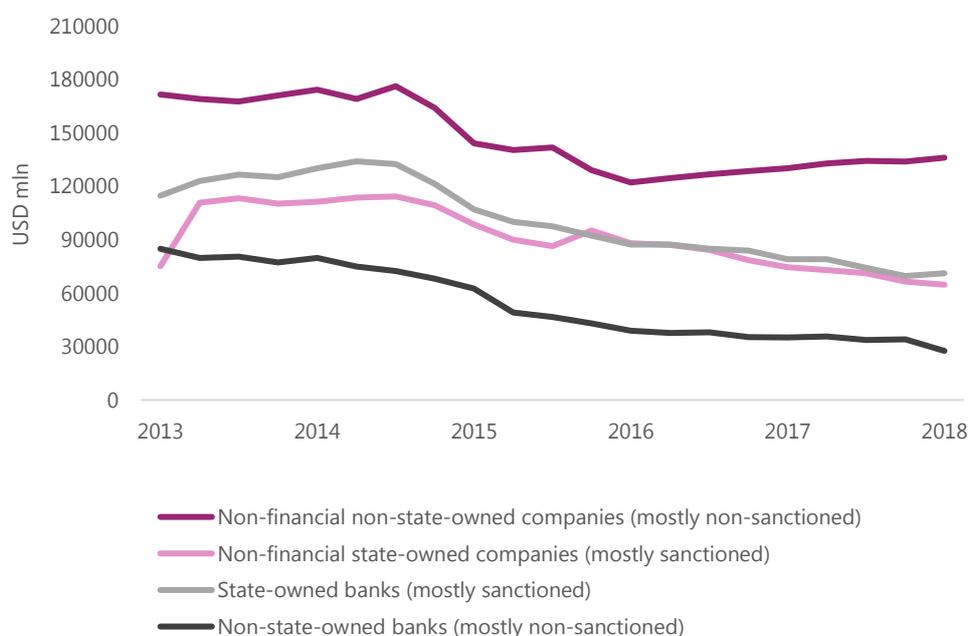
⁵ Debt obligations of LUKOIL are not subject to sanctions. Some Gazprom subsidiaries are subject to blocking sanctions.

A large number of sanctioned companies changed their geography of borrowings: the share of borrowings attracted from non-residents decreased. This trend is also typical for non-sanctioned companies (Fig. 5). The total debt of companies sanctioned in April 2018 is approximately RUB 1.5 trillion, of which 12% are bonds and 30% are ruble loans. Since these companies are subject to blocking sanctions that prohibit any interaction between them and US companies, the debt structure of sanctioned companies may change. This trend could be exacerbated by the concerns of non-US counterparts about secondary sanctions that may be introduced against them in the event of interaction with sanctioned Russian companies. At present, 57% of the debt of the entire Russian corporate sector and 16% of the total debt of the banking sector relate to companies from the sanctions list.

After 2014, the share of borrowings from US and European banks in the total bank debt of sanctioned companies decreased, while the share of Chinese counterparties increased correspondingly. This is not a consequence of the search for new investors in the East, since most of such borrowings were made before the first wave of sanctions. It is worth noting that China's continued economic growth creates the potential for increasing the share of its investments in the Russian economy. Traditionally, China invests heavily in the Russian oil and gas sector: the sector accounts for an average of 57% of all major⁶ Chinese investments into Russia (in monetary terms, USD 10.1 billion) made since 2006. The share of Asian countries in direct investments into the Russian economy has increased from 4.4% to 6.5% in 2014–2018, but this is also a result of Western investments waning on the back of sanctions (Fig. 6).

See [Chinese capital outflow restrictions give way to new opportunities for CIS countries](#) dated September 4, 2017.

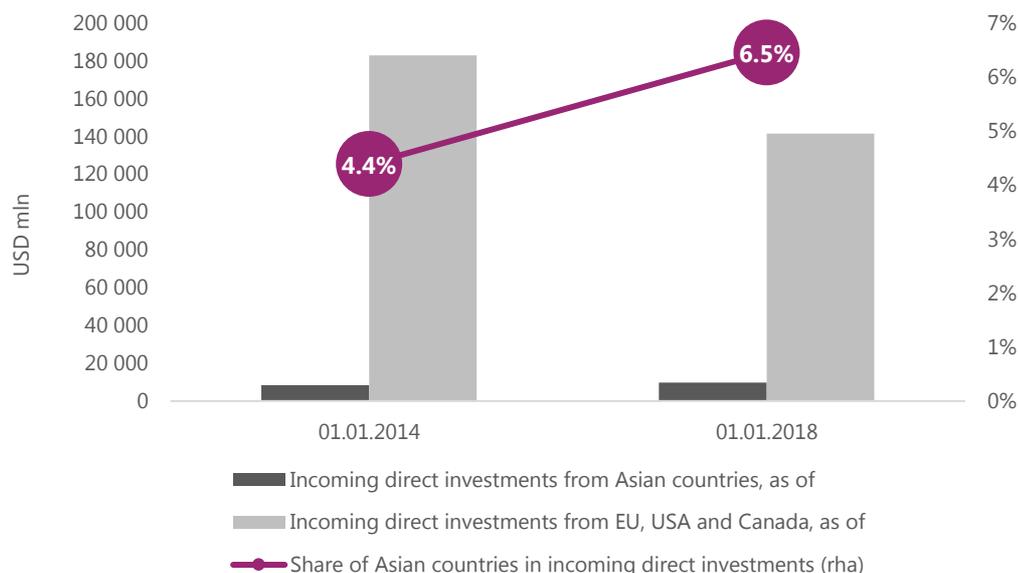
Figure 5. The external debt of state and non-state companies has decreased after the first wave of sanctions in 2014–2015



Source: Bank of Russia, ACRA estimates

⁶ Over USD 100 mln.

Figure 6. The volume of incoming direct investments has decreased; the share of West has dropped, the share of Asia has grown



Source: Bank of Russia, ACRA estimates

...but stronger—on the economic policy of Russia

The sanctions have both direct and indirect effects on the Russian economy (Table 2).

Table 2. Sanctions' effects on the Russian economy

Direct effects	<ul style="list-style-type: none"> Limited participation in joint technology-intensive oil and gas projects Lower export Financial performance of companies
Indirect effects	<ul style="list-style-type: none"> Changing economic policy Worse investment climate Restricted long-term growth

Source: ACRA

The indirect effects of the sanctions regime turned out to be more influential, as they affected the entire economy, and namely, they have led to certain changes in the following components of the national economic policy:

- 1) **Trade barriers.** Russian countersanctions have limited the imports of certain categories of food products, which led to an increase in their prices. The effect on real incomes of the population is estimated at -2–3 p.p. for 2018⁷. In 2014–2018, Russia's GDP grew by 1.1%, while the contribution of the countersanctions factor (through a decline in retail consumption) was only -0.2 p.p. The negative effect of countersanctions was not compensated in full by the positive effect of growing production in the agro-industry and lower imports. In this period, the contribution of agribusiness in the economic growth was 1 p.p., but it was mainly a result of investments made in 2010–2013. The production growth in the agribusiness sector directly related to countersanctions did not exceed 0.1 p.p.

Sanctions have accelerated the development and implementation of measures aimed at higher sustainability of the Russian economy and its financial sector, in particular. Some measures were to be implemented irrespective of any sanctions, though at a somewhat slower pace. The price of adaptation to sanctions includes certain losses in the national welfare.

⁷ The consumer basket price have grown by 2–3 p.p.

For example, the share of US treasuries in the Russian international reserves fell from 20% to 11% from January 2014 to April 2018.

- 2) **Financial market infrastructure.** The threat of disruption of the continuous monetary turnover accelerated the development of regulations that stimulate the use of internal alternatives of global financial services in the following areas: payment systems, credit ratings, etc.
- 3) **Data storage and software localization.** The need to meet the localization regulations increased the costs of technology-intensive and telecommunications companies.
- 4) **Fiscal policy.** The budget planning process is now based on assumptions that are more conservative. External borrowings are no more considered a reliable source of funding.
- 5) **International reserves.** The need to preserve liquidity has led to a change in the structure of investments: the share of sovereign securities issued by sanctions initiators has declined (probably, for a long period).

Sanctions will restrict the long-term economic growth

See ACRA forecast [Six investment drivers in Russia](#) dated April 4, 2018.

Sanctions cannot be considered a key deterrent to the mid-term economic growth in Russia. ACRA estimates the country's economic growth potential at 1.5% in the period from 2017 to 2018, and the actual figure is already close to this level. The growth is basically constrained by a decline in the workforce (according to ACRA estimates, the negative effect (in terms of the economic growth rate) of this factor is expected at -0.4 p.p. in 2018–2020); therefore, even in case the sanctions are lifted, the economy is unlikely to grow significantly in the medium term.

The impact of sanctions on the growth rates may be more tangible in the long term for both companies and the economy as a whole. The main barriers to faster growth, which would have been possible in the absence of the sanctions regime, are cancelled joint technology-intensive projects, lower aluminum exports, and lower oil and gas production.

Effects on joint technology-intensive projects

After the sanctions were introduced in 2014–2015, a number of long-term oil field development projects were canceled, including nine large joint projects of Rosneft and ExxonMobil. ExxonMobil lost its investments and Rosneft started to look for new partners and investors.

The 2014 restrictions imposed against oil and gas companies will affect the oil production rates in the 2020s. Those oilfields that were put into operation after 2013 should contribute to the increase in the total oil production in the period from 2019 to 2020, but in the 2020s, new technology and investment incentives will be needed for both brown fields and green fields. This process will require significant expenses but will be restrained by sanctions.

At the same time, the ban on the oil and gas upstream equipment export to Russia was positive for the domestic power engineering industry and oil equipment manufacturers.

Effects on exports

Due to the sanctions imposed on UC Rusal, aluminum exports from Russia to the USA may decrease by 5–10% in 2018. The growth rate of aluminum sales in the domestic market is not high enough (in 2018, the rate will grow by 3–4% due to a change in the standards applicable to aluminum products) to neutralize the effect

of reduced aluminum exports to the West. However, in 2019, the negative impact of sanctions may dwindle due to the growth of both aluminum exports to China and aluminum consumption in the domestic market.

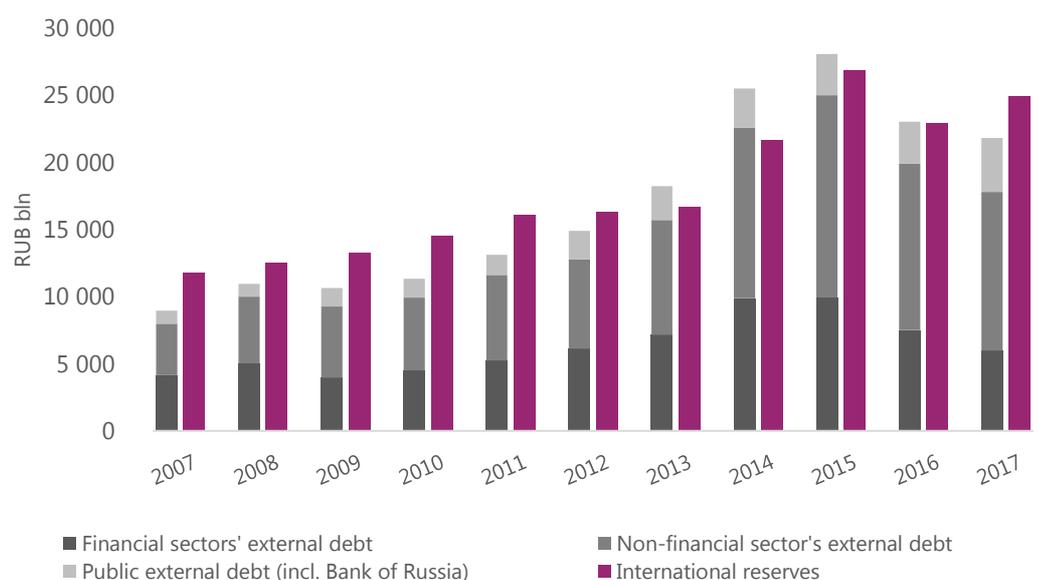
Russia's international reserves cover the entire corporate debt vulnerable to stricter sanctions

The risk of extended sanctions will remain one of the key risks that the Russian economy may face this year. Further sanctions, if any, may include the following:

- New restrictions against the companies already sanctioned (e.g., a ban on shorter term borrowings);
- Imposition of sanctions against non-sanctioned companies;
- Extension of sanctions geography: other countries imposing similar restrictions; secondary sanctions against counterparties dealing with sanctioned Russian persons/entities;
- Restrictions on transactions in Russian sovereign bonds;
- Other sanctions (limiting the liquidity of CBR's reserves, SWIFT cut off, etc.).

In 2017, the volume of international reserves reached the point high enough to cover all Russian external debt vulnerable to forced repayment (Fig. 7). This can eliminate liquidity risks, so that no direct negative impact on the sanctioned companies may arise, although the investment climate may deteriorate. After the imposition of sanctions in April 2018, the share of non-residents holding Russian government bonds fell from 34.5% to 30% in the period from April to June (in 2H2014, the share fell from 25.6% to 18.7%).

Figure 7. In 2017, the volume of international reserves reached the point high enough to cover all Russian external debt vulnerable to forced repayment

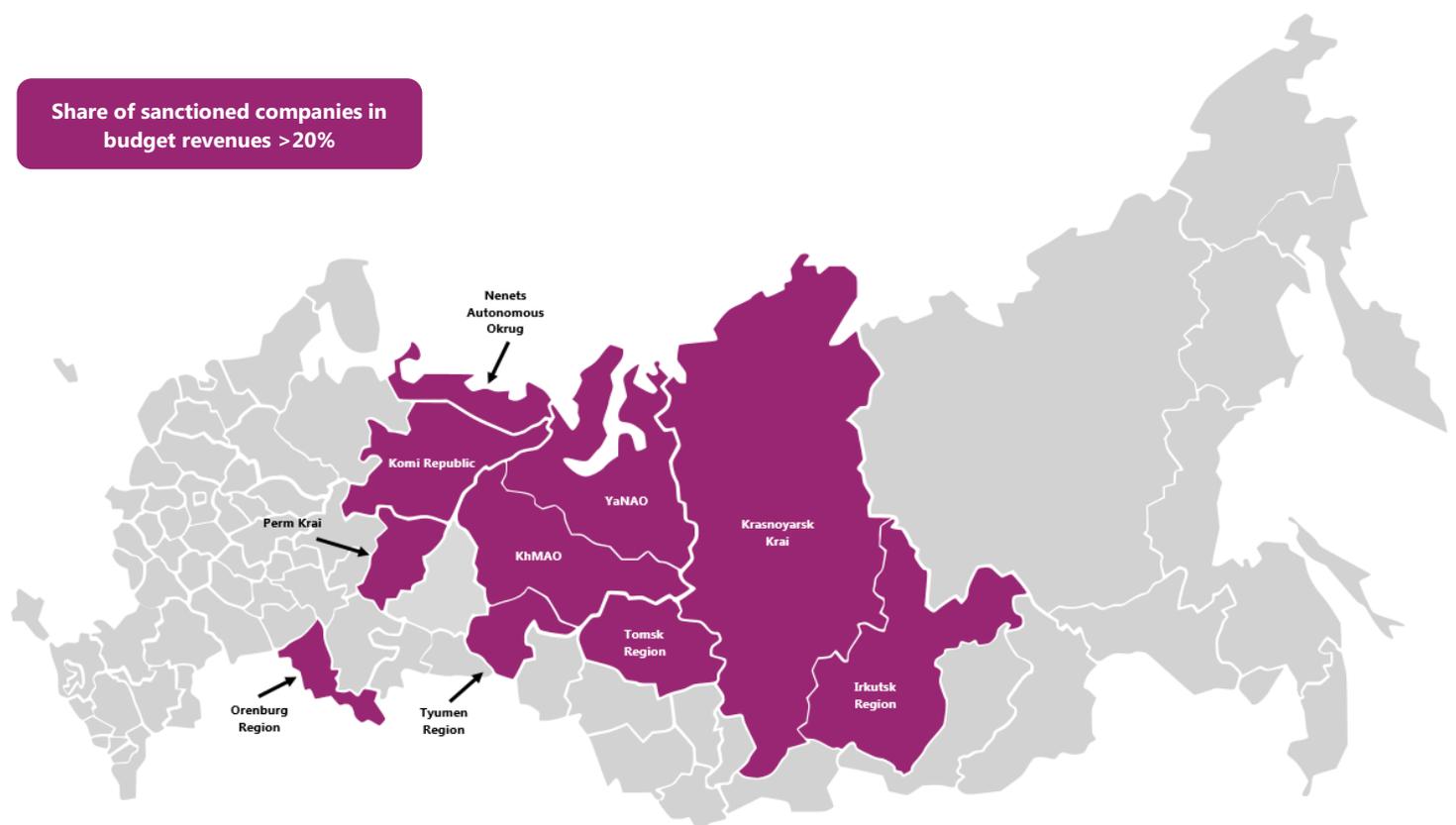


Source: Bank of Russia, ACRA estimates

Possible new sanctions being discussed include restrictions on transactions in Russian government bonds, limitation of liquidity of CBR's reserves, and SWIFT cutoff. It is worth noting that the first scenario looks unlikely, since the US government acknowledged that they could negatively affect the US economy.⁸ Second and third scenarios are possible, and their effects can be the most tangible.

Currently, the budgets of 10 out of 85 subjects of the Russian Federation depend on sanctioned companies by more than 20% (Fig. 8). Those are mainly regions where oil and gas are extracted. The expansion of sanctions may lead to a decrease in profit tax revenues, but the negative effect may be partially offset by stable budget revenues from personal income tax, property tax and excise taxes.

Figure 8. Regions whose budgets depend on sanctioned companies by more than 20%



Source: ACRA estimates

⁸ See <https://home.treasury.gov/news/press-releases/sm0271> and <https://publicintelligence.net/ustreasury-russia-sanctions-2018/> of February 2018.

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