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Assessment of Initial Impacts of Western Sanctions against Russia: Effects for Azerbaijani Economy

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Literature Review

Repercussions of the western sanctions on the Russian economy increasingly arise that negatively affect the total economic structure. National GDP shrank by 4.3% in the first quarter of the current year. As forecasted by the Russian Central Bank following the exposure to sanctions, a 7 percent reduction in the GDP could be expected in the third quarter. Russian ruble lost its value by 7 percent against the dollar in less than a month which even resulted in an inevitable devaluation in the official exchange rate. Even though Russia is faring better in terms of energy revenues, negative consequences of investment outflow from the country can not leave the real sector unaffected. On the other hand, a number of sanctions will enter into force by the end of the month. This, in turn, indicates observable economic setbacks in the country. According to the analysis carried out by Sonnenfeld (2022) business retreats and sanctions are catastrophically crippling the Russian economy. Russia's strategic positioning as a commodities exporter has irrevocably deteriorated, and despite some lingering supply chain leakiness, Russian imports have largely collapsed, and the country faces sharp challenges securing crucial inputs, parts, and technology from hesitant trade partners. As a result of the business retreat, Russia has lost companies representing ~40% of its GDP. Russia and its most important trading partner – the European Union – have in many ways become less integrated as a result of Russia-Ukraine war and violations of international laws(Korhonen, 2020).

Across a range of metrics, Russia's economy is worse off than it was before Russia expanded its invasion of Ukraine. The International Monetary Fund[1] projects that in 2022 Russia's economy will contract by 8.5%, inflation will reach 24%, and unemployment will double to 9.6%. Sanctions have disrupted Russia's real economy—the production, purchase, and flow of goods. The volume of Russia's trade has contracted sharply (Russia's imports by volume are forecast to fall by nearly 25% in 2022), and more than 750 international companies have retracted operations in or with Russia(Sector et al., 2022). Russia exported more than half of the coal produced domestically that indicates the introduced coal ban to the loss of foreign exchange reserves and increasing unemployment(CESD Press, 2022). Global economic consequence of the invasion was a global supply chain disruption. This manifested through energy supply shocks, and trade supply shocks. It led to rising energy prices, rising commodity prices, and a rise in food prices, thereby leading to a rise in global inflation in many countries(Ozili, 2022).

The geopolitical tension, threats of sanctions and the imposing of sanctions have produced a crisis of confidence that has hurt the willingness of both domestic and foreign actors to embark on business ventures in Russia and to invest(Skak, 2016). Mbah & Wasum,(2022) estimate that the war to contribute to a fall in GDP in Russia (relative to base) of 1.5 per cent in 2022 and 2.6 per cent by the end of 2023. Russian inflation is likely to soar above 20 per cent this year due to higher import prices following the fall in the rouble and due to higher inflation expectations, resulting in lower confidence, weaker real incomes, and disrupted trade. In addition the authors expect actions against Russia could reduce foreign direct investment,

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[1] https://www.imf.org/en/Home

leading to outflows of capital, and reducing its long-term potential growth rate(Mbah & Wasum, 2022).

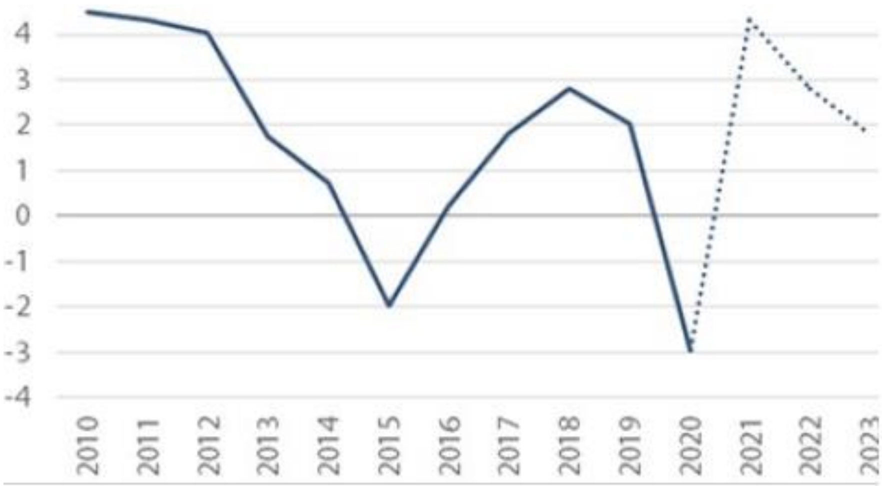
The resource based economies of Russia as well as Azerbaijan are confirmed to be subsidized economies, or based on government spending financed by resource windfalls, and the non-resource sectors in the oil- exporting country such as Russia were poorly developed that can act act as an avenue for diversification under the regime of tough sanctions(Bayramov & Abbas, 2017). Thriving non-resource sectors in these economies were highly dependent on resource windfalls(Bayramov & Orujova, 2017). The following isolation of Russian from the main international trade partners will lead to economic recession in the Russian economy doubled with obstacles in the international monetary transfers that can negatively affect the non-oil exports of Azerbaijan as Russia's share in this vein is the backbone of the segment(Mustafayev, 2022). Spillover effects of the sanctions for Azerbaijan are highly likely to emerge in the form of import-export and supply chain disruptions, additional inflationary pressures, shortage of remittance inflows(Mammadov, 2022).

Assessment of Initial Impacts of Western Sanctions against Russia

In conjunction with a tough package of sanctions, the EU intends to refuse the purchase of Russian gas by 92 percent until the end of the year which is being further exacerbated by the difficulties in political scenario. The before-mentioned factors will certainly be translated into decreasing currency inflows bringing further devaluation impact on ruble. As envisaged previously, the consequences of the sanctions on Russian economy have been evaluated not only from the short-term perspective, as well as from medium and long-term perspectives. Recession scenarios around the globe are gaining momentum recently and global forecasts imply a decline in some respects and the Russia-Ukraine war enters a new stage.

Russian economy went through negative damage by the exit of international business from the country. Although Moscow retained a large amount of energy revenues due to elevated prices, economic activities at the domestic level stalled. The consideration of the damage from the sanctions dated back to the 2014 Russia-Ukraine conflict pushed the government to replace imports with some domestic production. However, the country's industry remained heavily driven by foreign capital investment and the import of higher-tech inputs that Russia had a weaker capacity to produce. Some 1,000 foreign companies halted their activities in the country, potentially affecting up to 5 million jobs.

Figure 1: GDP growth of Russia forecasted before the war



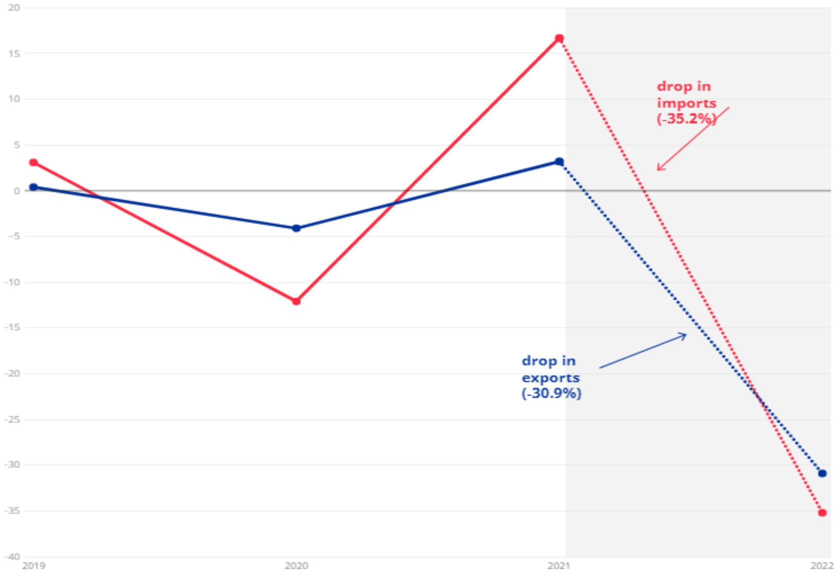
Source: World Bank, 2022

Figure 2 Russia's adjusted GDP growth and forecast

Source World Bank, 2022

In comparative terms, figure 1 and figure 2 illustrate the state of the Russian GDP until 2020 and forecasted in 2021 and 2022 before the war and on the recent adjusted GDP outlook of Russia after the sanctions respectively. Sanctions were certainly important factors that drove the Russian economy into recession in 2015 and in 2022 respectively. Even after recovery in 2015, growth still stood below pre-2014 levels. Sanction effects appear to be in the forms of declining trade and soaring inflation as well. Although before the war barely considerable decline was projected, the consecutive package of sanctions is projected by World Bank to result in -11.2% reduction of Russia's GDP.

Figure 3 Russia's forecasted import and export declines



Source: World Bank, 2022

Restrictive measures in addition target to include the import and export of certain goods and services. Figure 3 clearly exhibits trade upswing in imports and exports of Russia after 2020. However, following the global pandemic coupled with inevitable repercussion of sanctions, the world bank estimates suggest a significant decline of Russian trade in goods and services showing that Russia's imports in 2022 will dwindle by 30.9 percent, while exports in 2022 will diminish by 35.2 percent.

Figure 4 Russia's inflation rate

Source: World Bank, 2022

Following the economic turmoil and disrupted production and supply chains, decreasing resource-windfalls, rising level of inflation is inevitable. Although Covid-19 laid down first signals of inflationary pressures, figure 4 depicts the Russian inflation rate will increase dramatically after sanctions reaching 22 percent in 2022[2] as forecasted by World Bank. This will certainly place a pressure on the price of goods and services exported to Azerbaijan increasing the rate of import inflation.

Implications for Azerbaijan

Current estimates seemingly show that the impact of the imposed sanctions in place is visible that can certainly affect its neighborhood with spillover channels. The global economic consequence of the invasion was a global supply chain disruption in addition to others which has been manifested through energy supply shocks, and trade supply shocks. It led to rising energy prices, rising commodity prices, and a rise in food prices, thereby leading to a rise in global inflation in many countries, in particular in the neighbourhood. The implication is that geopolitical conflicts tend to have spillover economic effects to other countries and that such conflicts do not have isolated effects on the sanctioned country. The Russian-Ukraine conflict has shown that sanctions against a warring country is not an optimal solution because it has spillover effects into other countries who are not part of the conflict, specially in the countries with close economic ties to the ones involved in the conflict.

With the emergence of the war, experts were warning of the global food shortages around the world. In 2021, Azerbaijan approximately imported imported goods from Ukraine and Russia in the value of 470 million$ and 2.74 billion $ respectively. According to the statistically committee, Azerbaijan imported nearly $300 million of wheat from Russia, as well as timber materials worth $100 million and vegetable oils worth $46 million that indicates the crisis has the possibility to spark a food shortage to some extent if measures are not timely taken. Azerbaijan do not seem to be able to replace Russian and Ukrainian products with imports from other countries in the near future. When the law of supply and demand is violated, of course, this affects prices. Today, the government of Azerbaijan prioritizes the issue of increasing domestic production as there are enough opportunities for small businesses.

In the year 2021, total trade turnover between Russia and Azerbaijan accounted for 2.295 bln USD with a 12% upsurge1 recovering to pre-pandemic levels. Russia ranked as the 3hd largest trade partner of Azerbaijan in 2021 following Italy and Turkey. Spillover effects from the economic recession in the third largest trade partner are expected that appear to be in the form of remittance shortages that experience reductions due to various reasons. Due to rising unemployment and sanctions on businesses Azerbaijani expatriates in Russia lose their jobs and income source. With sanctions, Russian currency is being devalued , which produces less value after conversion in dollar terms. All this taken into account, results in the reduction of the transferred remittances to Azerbaijan. In addition, import-export and supply chain disruptions. Additional inflationary pressures are predicted in the form of imported inflation with the imported goods and services because of increasing production costs abroad. The war posed disruptions to the shipment and trade of vital food products that stipulates the

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[2] https://www.consilium.europa.eu/en/infographics/impact-sanctions-russian-economy/

government of Azerbaijan to take control the possible emerging food scarcity in the globe although the country is highly unlikely to suffer from it in the short term.

On other hand, increasing revenues from energy prices provide a background for Azerbaijan to generate more resource windfalls in the short term due to shrinking oil supply market. As result, inflowing foreign currency reserves supports the stability and reliability of the national currency and exchange rate system creating significant surplus in the Current Account that can be an another milestone in stepping up the implementation of nationwide projects and reforms. Rising oil prices have pushed Azerbaijan to increase its state budget, with much of the spending earmarked for defense and reconstruction in Karabakh. Notwithstanding with positive dynamic experienced in the oil market, stability in the oil market is necessary for energy exporters in terms of foreign currency inflows. Certainly, formation of oil prices are not only subject to economic factors, but also subject to political factors. This unpredictable volatility once more stipulates the need for energy dependent countries to accelerate the diversification of the economy and reduce energy dependency. As one of them, Azerbaijan prioritizes to minimize its dependence on hydrocarbon revenues.

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