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The economics of sanctions: The West can afford to be tough

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So far the West has chosen a reluctant approach in its attempt to contain Russia's encroachment in Ukraine, refraining from economically or financially meaningful sanctions. While heightened tension in Eastern Ukraine is significantly raising the probability of another escalation in the sanctions, the indirect consequences of the standoff with the west – a massive acceleration in capital outflows – is already generating significant adverse consequences for the Russian economy. Russia is in a good position to mitigate this, with still comfortable foreign exchange reserves and a very small net debt. Still, while for now we expect Russian GDP to grow at a paltry 0.6% this year, we cannot discard the possibility of a replication of the 10% decline in output observed during the Rouble crisis of the late 1990s.

A major Russian recession would have a noticeable impact on Europe's Eastern rim, with the countries suffering a drop in their GDP. The impact on the German economy – the only big euro area country with a significant trade exposure to Russia – would be in the order of 0.5 pp: certainly not negligible, but manageable in a country for which our GDP growth baseline this year stands at 1.8%. After all, trade with Russia accounts for not even 4% of Germany's total trade. The euro area recovery would be dented, but the Russian economy is not large enough, in our view, to trigger a full relapse.

Obviously, the economic cost would be higher if Russian supply of energy to the West was jeopardized, but this would come at a very high price for Russia itself, as this stands at 10% of the Russian GDP.

The US seems to favour an extension of financial sanctions, which would bring Europe with its bigger economic and financial links to Russia in an uncomfortable position. Of course any estimation of the impact of financial sanctions is much more uncertain than assessing trade restrictions, but again, unless a full-on default on Russian debt occurs, the consequences for the West, on aggregate, would be manageable.

The Ukraine crisis and further sanctions will not be inconsequential for the profile of the European recovery, but when looking at the distribution of costs, it seems that the West can afford to be tough towards Moscow.

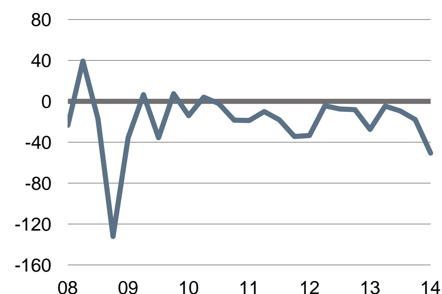
Capital outflows are a serious blow to an already anaemic Russian economy

Western sanctions against Russia have gradually escalated over the last couple of months as the crisis in Ukraine has gone unresolved. At this stage, sanctions have been imposed mostly on individuals. The EU has frozen the assets and restricted the travel of 61 Russian and Ukrainian nationals, mostly linked with the secession and annexation of Crimea as well as leaders of pro-Russian secession movements in eastern Ukraine and recently added two Crimea-based companies to the list. The US has imposed similar restrictions but targeted more squarely at President Putin's inner circle of officials and confidants, including a number of companies and banks owned or controlled by them. More recently, the US has also banned the export of high-technology goods that can be used for military purposes.

Both the US and the EU have threatened to impose further sanctions if necessary. The US has already adopted an executive order giving it the authority to extend sanctions to key sectors of the Russian economy, such as financial services, energy, metals and mining, engineering, and defence. The EU may find it more difficult to move in this direction for political and legal reasons, though the European Commission has been asked to prepare broader economic and trade sanctions. The EU and the US have agreed to impose wider sanctions if Russia "disrupts" the Ukraine elections.

Net capital inflows 1

Private sector, USD bn



Source: IMF

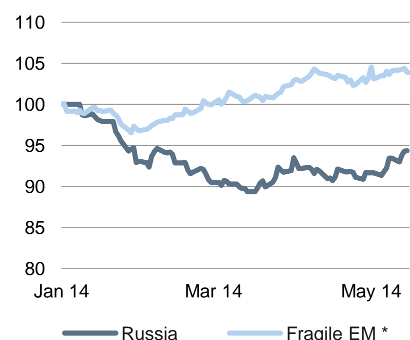
At this stage, the direct economic impact of sanctions has been limited, reflecting their targeted nature. The Russian companies and banks subject to US sanctions, for example, are small and have limited international economic and financial exposure. None of them are publicly listed. While the heads of some of Russia's largest state-owned companies (such as Igor Sechin, the CEO of Rosneft) have been individually sanctioned, they do not have a controlling interest in those companies, which have thus escaped the sanctions net.

The indirect economic impact has been larger. Capital outflows have increased, the rouble has weakened, inflation has accelerated, and domestic liquidity conditions have been tightened. This will be enough to choke off what had already been an anaemic economic recovery.

— Capital outflows have been a feature of the Russian economic landscape for many years but have accelerated notably in recent months. Some USD 51bn left the country in the first quarter of the year, only a little less than the entire annual outflow in the preceding two years.

Exchange rate 2

Local currency vs. USD, 01.01.2014=100



*) Brazil, India, Indonesia, South Africa, and Turkey

Source: Bloomberg Finance LP

— The rouble weakened by 10% between the start of the year and mid-March. It has recovered a little in recent weeks at the Central Bank of Russia has sold some of its reserves to limit the pressure. Inflation has risen from 6% to 7.3% since the start of the year and will likely rise further in the next few months as prices continue to adjust to the weaker rouble. The Central Bank of Russia has raised interest rates by 200 bps to 7.5% to try to keep inflation in check.

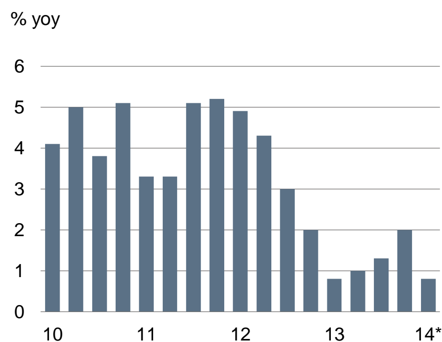
— The cost of financing more broadly has increased. Prime lending rates in Moscow, for example, have jumped to 10% from 7% in late-February. Corporate debt issuance is running at its lowest level since 2009. Government bond yields have risen to about 9.5% from a little less than 8% at the start of the year. There is a significant risk that the sovereign could lose its investment grade status if the crisis continues to escalate.

— The economy had already begun to slow sharply following elections in early 2012, with growth dipping well below 2% over the last year or so.

Preliminary data suggest that the economy grew by less than 1% in the first three months of the year and that output may actually have fallen after accounting for seasonal effects.

Real GDP growth 3

% yoy



*) based on prelim. estimate from Ministry of Economy

Source: Russian Ministry of Economy

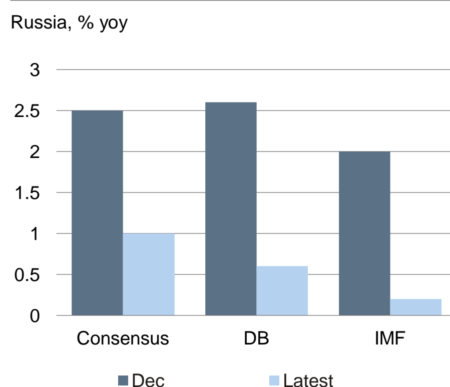
Even assuming a relatively swift resolution to the crisis in Ukraine in the second half of the year and limited new sanctions, we think the economy will struggle to grow by much more than 0.6% this year. But the risks to this outlook are skewed very clearly to the downside.

It is difficult to quantify the impact of fresh sanctions or hostilities in Ukraine. But anything that affects trade in energy would be especially damaging: it accounts for about one-quarter of GDP, half of government revenues, and two-thirds of exports. Russian oil and gas supplies to Europe are worth about 10% of Russian GDP. European or Russian restrictions on these supplies seem unlikely given the mutual damage it would cause, though supplies could be disrupted in the event of significant hostilities in Ukraine. Other broad sanctions, for example targeting the banking sector or key state-owned companies, would further raise the cost of finance and hit investment.

Russia's balance sheets are strong enough to enable it to withstand significant economic pressure. Even after recent intervention, foreign reserves are still USD 471.1 bn, more than enough to cover the roughly USD 200 bn of (almost entirely private) external debt falling due this year. The government balance sheet is also in good shape. Net government debt, including assets in Russia's oil savings funds, is only around 4% of GDP. The weaker rouble is also helpful in boosting the local currency value of government oil receipts – the depreciation so far this year has boosted revenues by some 0.8% of GDP. The central bank will therefore be able to strike a balance between using some of its reserves to offset the withdrawal of foreign liquidity (and the increase in domestic capital flight) while at the same time accommodating some further weakening in the rouble. The government has some scope therefore to boost public spending. Such steps could help to limit the economic fallout from a further escalation of the current crisis. But they would not be enough to avert a significant tightening in domestic liquidity conditions and hence a sharp economic contraction.

Real GDP forecasts for 2014 4

Russia, % yoy



Sources: IMF, Deutsche Bank Research, Bloomberg Finance

All in all, therefore, with the Russian economy carrying very little momentum going into the current crisis, it would not take much to tip it into a recession if, indeed, it is not already in one. A protracted standoff over Ukraine and continued uncertainty alone would probably be enough to do the trick. A significant escalation of hostilities and the imposition of material economic and financial sanctions would likely turn this into a deep recession. Whether or not this would approach the 10% declines in output that we saw in 1997-98 and 2008-09 is hard to say. Domestic economic imbalances were much larger in 1997-98. The global backdrop, including the collapse in oil prices, was much worse in 2008-09. The shock facing the economy right now is entirely different in nature but it is entirely possible that the impact will be similar.

Even an adverse scenario is likely to be manageable for Western Europe

The most obvious transmission channel here is trade, in case of steep contraction in Russian demand as a consequence of heightened capital outflows and/or more meaningful sanctions. Russia receives 4.7% of euro area exports, equivalent to two thirds of the share of China. This is not a marginal direct partner for Europe, but even the second round effects of a contraction in Russian GDP over the global economy would be manageable. Indeed, Russia's share in world imports (2%) is only a fifth of that of China.

The economics of sanctions: The West can afford to be tough

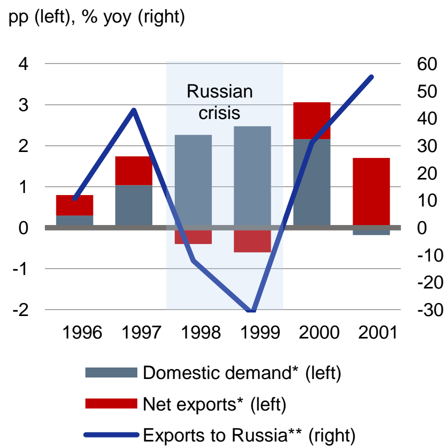
German trade with Russia 5

Share in total goods ex- and imports, %

Source: Federal Statistical Office

Germany: Economic growth & exports to Russia (1996-2001) 6

pp (left), % yoy (right)

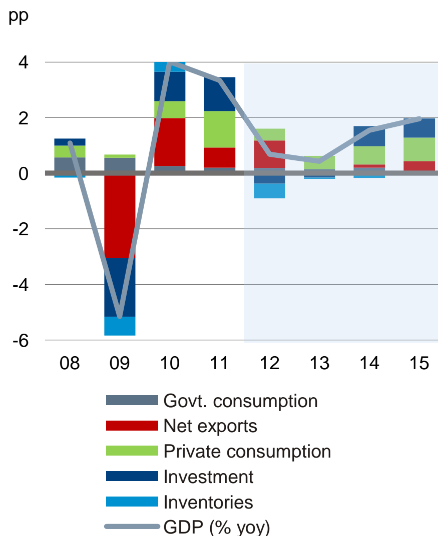


*) Contribution to GDP growth
**) Nominal exports

Sources: IMF, Federal Statistical Office

Germany: Growth contribution 7

pp



Sources: Federal Statistical Office, Deutsche Bank

Within the euro area, some small countries of the Eastern rim (Finland, Estonia) would be meaningfully exposed to a contraction in Russian demand, with a share of Russia in their total exports of around 10%. In the big countries, the direct exposure to Russia is quite limited, not only because for France, Italy and Spain the share of Russia in their exports never exceeds 2.5%, but also because the share of total exports in GDP is relatively limited.

Germany is the only big country for which trade with Russia really matters. Russia accounts for 3.3% of all German goods exports[1] (rank 11; in 2005 it was rank 13), exceeding 1.5% of GDP. The Russian share in total German exports has been increasing during the last few years. The automotive industry and mechanical engineering are by far the most important sectors, accounting for 43.5% of Germany's exports to Russia. However, exports to Russia account for 5% of total mechanical engineering exports and 4% of automotive exports. The clothing industry (which is not important in Germany at all) has the highest exposure with a share of 5.5%. All other sector's export shares to Russia are below 4%.

A materially adverse scenario for the Russian economy as sketched at the end of the previous section would trim around 0.5 pp of German GDP growth. Assuming a drop in Russian GDP of almost 9% – similar to the Russian crisis in 1998/99 – the growth contribution of net exports to German GDP will be 0.3 pp lower. This includes direct and indirect effects (via third markets based on the OECD interlink elasticity). Such effects could stem from rising energy prices impairing the recovery process in the EMU or Eastern European countries being hit harder by trade sanctions. In addition, lower imports were factored in given the high import dependence of German exports. Lower exports and heightened uncertainty would in turn curtail investment as well as private consumption (both would also lower imports) which would dampen German GDP growth by an additional 0.2 pp.

However, the impact ultimately depends on possible substitution effects from domestic and external demand. In our baseline scenario of a US-led global expansion and robust domestic demand in Germany (we are expecting 1.8% GDP growth in 2014 and 2% in 2015) the effects of a Russian slump should be manageable. During the Russian crisis in 1998/99 Germany's real export growth decreased from 11.5% in 1997 to 5.8% in 1999 (with exports to Russia falling by around 40%) and the growth contribution from net-exports swung from +0.7 pp (1997) to -0.6 pp (1999). However, GDP growth did in fact inch up slightly from 1.7% to 1.9% courtesy of stronger domestic demand, which rose from 1% in 1997 to 2.6% in 1999.

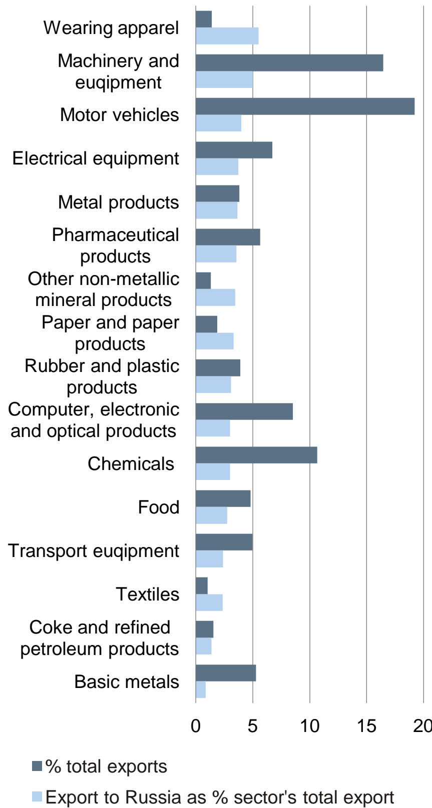
Assuming that the Russian crisis leaves deeper scars in the global economy, resulting in 0.5 pp lower global growth than in our baseline scenario, Germany's export growth would be 3 pp lower and net exports' growth contribution would be reduced by 0.8 pp, resulting in a total 1 pp dampening of German GDP growth (including the effects on investment and private consumption). These estimates are roughly in line with the results of internal scenarios produced by the European Commission reported in the media.

All said, our baseline scenario of no further material escalation in the conflict and Russian GDP growth of 0.6% would have an impact on German GDP growth which is within the margin of error of our conservative 1.8% forecast.

[1] The share in Germany's non-EMU exports was 5.3% in 2013 and, thus, higher than the share of Russia in Eurozone's total exports of 4.7%.

The energy issue: a material cost for both parties

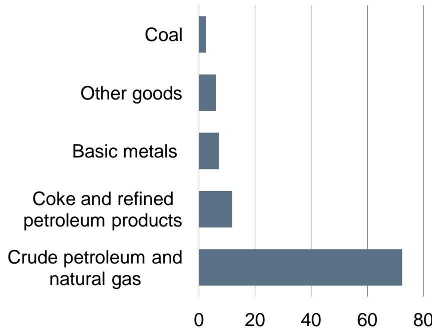
German industry: Export dependency from Russia 8



Source: Federal Statistical Office

German imports from Russia 9

Share in total imports, 2013, %



Source: Federal Statistical Office

The impact on German energy supply and energy policy will be low if escalations can be avoided. Short-run adjustments in the gas market might become necessary, if Russia were to reduce gas exports – Russia currently supplies 38% of German gas consumption – or stop shipments temporarily. We do not expect this to happen, however. If it were to happen, Germany would, by Q4 2014 at the latest, have to import more from other sources such as Norway (currently supplying 20% of Germany's gas consumption), or the Netherlands (26%) or even tap more heavily into domestic sources (10%).

President Obama signalled at the EU-US summit in Brussels on March 26 that the US would politically support US exports of energy to Europe. In the short run, however, the technical capacity to produce LNG (liquefied natural gas) and ship it to Europe is not in place. Whereas in the heating sector, gas shortages might become a problem, the electricity sector does have some substitution options provided by coal. Overall, the government is correct in stating that Germany's energy vulnerability is manageable. Any Russian tinkering with its gas deliveries might ultimately induce major buyers to shift away from Russia in the medium and long term, which would be highly problematic for Russia's budget position and economic situation in general.

A 50% reduction in gas supplies from Russia (around 80 bcm) could potentially be offset by redirecting LNG (e.g. from the Middle East) committed to Asia back to Europe, fuel oil substitution and running hard coal plants at higher capacity utilization than originally planned (so far it is limited by regulation to reduce carbon emissions). There are likely to be bottlenecks in European power/gas networks but in our view these are manageable. We estimate a 50% reduction in Russian supplies to boost gas prices by at least 50% as would be the precondition for redirecting some of the higher priced LNG from Asia to Europe (given that gas costs in Europe are USD 8/mmbtu vs. Asia at USD 16/mmbtu) and most of the LNG is already committed until mid/end 2015. In Germany the merit order effects are already leading to a decline in gas power generation. If gas imports were to decline dramatically the first step could be an increase in coal power generation. In our view, dramatic developments would have to occur in order to trigger a new debate about delaying or stopping the nuclear phase-out, but this will certainly happen if a dramatic shortage occurs.

Note that while there would be a manageable financial and political cost to some reshaping of Germany's energy policy, European support for some its members – in case of a decline in Russian supply – would probably need to be considered. Indeed, the EU member states with the most intense trade links with Russia tend to be those which are the most dependent on Russian energy: 100% of gas consumed in Finland comes from Russia

Beyond the immediate technical issues, any additional disruption to gas supplies would in our view result in much higher gas prices and would mean that gas supply would have to be prioritised as 40% of gas is used for heating, 30% for industrial usage and 30% for power generation, with cuts in industrial gas supply having the largest GDP impact.

50% higher gas prices would imply a strong hit for German corporates' operating margins. This would be most strongly felt in the utility sector, which is already in part making losses. In general, every 1% increase in total costs due to higher energy prices results in a 0.5 pp decline in corporates' operating margins, assuming other energy prices to rise in parallel. Energy costs are on average around 2% for Corporate Germany and the 10-year average operating margin is 7.6%.

Financial sanctions: Ways, means and implications

Freezing Russian assets held in the US and the EU could be one of the next steps in terms of sanctions.

So far, the sanctions imposed on Russia have been on a small scale, aimed at a short list of persons and a few economic entities, not at Russian state institutions or large corporates. Also, they have not been consistently applied, with the US targeting a somewhat larger list of persons than the EU. These limitations tend to weaken their impact and increase the targets' ability to evade them.

Persons proscribed by the US are to have their assets blocked by any US person or entity that manages, intermediates, or owes them. Transactions in dollars are also blocked – in particular, since dollar based transactions must pass through a payment system controlled by US persons, such flows can be channelled into blocked accounts as the order flow emerges. US depositories and asset managers also must block accounts of designated entities. Any entity acting as agent to circumvent the blockage of designated persons can also be designated and have its assets blocked, to the extent that they can be identified. Effectively, this allows the sanctions to be extended to an unlimited extent as secondary boycotts as long as such extensions are not too geopolitically costly.

If similar actions were to be taken by EU countries these could – combined with US sanctions – potentially encompass most assets held abroad and international payments made, as has happened in the notable case of Iran. Additionally, especially robust EU participation would enlist SWIFT into the action and substantially block most proscribed payments because SWIFT messaging is used for transactions in most currencies. But since the EU has a great deal to lose in exports and especially energy imports, the cost to the EU of such tough financial and payments sanctions would be very large compared to the US, so, barring an overt Russian invasion of Ukraine, the EU will likely avoid being as stringent as the US. However, involving SWIFT, a private institution owned by its member banks, could undermine its central role in the global financial system as it might accelerate moves to set up substitutes elsewhere.

The current slow-motion imposition of financial sanctions has permitted opposing gross claims to be cancelled as creditors on both sides repatriate funds during this "phony financial war" period. This will defuse somewhat the possibility of serious balance sheet problems that will have to be sorted out on both sides if the asset freezes become very serious, leaving only the net claims of Russia at risk.

Still, we need to consider a case in which Moscow might retaliate by freezing foreign assets in Russia, or where the creditworthiness of Russian assets could materially decline as a consequence of an escalating crisis. BIS statistics provide a good indication of the implications of such a move for the international banking sector.

In absolute terms, French banks are – by far – the most exposed, with USD 51 bn claims (loans and securities) over Russia in Q3 2013.However, these claims must be compared with total bank assets in each country to get a sense of the systemic impact that an asset freeze or deterioration in the creditworthiness of Russian assets could have. Austria then comes out with the highest ratio (1.4%), followed by the Netherlands and Italy.

We suspect these risks are fairly tightly concentrated in a small number of banks in each country – which adds to the systemic risk – since lending outside of the

euro area is not an operation on which “bread and butter” institutions would easily embark.

At the other end of the European spectrum, in Germany and even more so in Spain, exposure to Russian risk through the financial channel is very limited (respectively 0.2% and less than 0.1%).

In aggregate, the sensitivity of the European banking sector to Russian risk is significantly larger than that of its American and Japanese counterparts. True, the picture changes once one adds to claims over Russia what the BIS classifies as “other exposure” (derivative contracts, guarantees and trade credit). Indeed, the US banking sector’s “wealth at risk” on Russia then rises by USD 92 bn, to a grand total twice as large as France’s.

Yet, the overwhelming majority of this “other exposure” comes from “guarantees”, which probably reflect CDS contracts underwritten by large international banks located in the US (as well as in the UK). As long as Russia does not default on its securities, this contingent liability would have little impact on the international banking sector.

Note that beyond asset freezes or deterioration in credit worthiness, the international financial system may have to deal with the potential disruptions stemming from a possible ban on trading with Russian financial institutions. This could have implications for liquidity and profits, but data on this type of relationship is too patchy to make any attempt at quantification worthwhile.

In a context of general pressure on banks’ capital ratio, heightened impairment risk cannot be neglected. Still, for this to occur we would need to consider here an extreme case where Russia would either default or accept to cut itself entirely from the international financial system. The consequences for the Russian economy would, in our view, be much more difficult to manage than the side effects for Western Europe.

This is also true for the longer-term effects of Russia’s aggressive moves. Even if a further escalation can be avoided, Western companies will likely think twice before investing capital in Russia on a longer-term basis, which, however, is desperately needed for the modernisation of the Russian economy. But even in the West, the reassessment of the geo-political situation might result in an at least partial pay-back of the peace dividend gained after the fall of the Iron Curtain.

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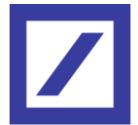

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