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The economic effects of the EU's Russia sanctions and Russia's counter sanctions

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Foreword

On 18 August 2014, a Meeting of Permanent Secretaries established a working group to assess the economic effects of the EU's Russia sanctions and Russia's counter sanctions by the time of the budget session. The Ministry of Finance, the Bank of Finland, the Ministry of Employment and the Economy, the Ministry of Agriculture and Forestry, the Ministry of Transport and Communications, the Ministry for Foreign Affairs, the Prime Minister's Office and the Government Institute for Economic Research have participated in the work. Senior Adviser Markku Stenborg of the Economics Department of the Ministry of Finance served as secretary to the working group.

The working group will submit its report to the Government on 27 August 2014.

Director General Markus Sovala,
Chair of the Working Group

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The economic effects of the EU's restrictive measures directed at Russia and of Russia's counter sanctions

- Russia's economic growth has already slowed down since 2013, for reasons independent of sanctions, and this has been reflected in Finland's economic development.
- As a consequence of the import ban imposed by Russia in early August, Finland's food exports will fall to less a quarter of the normal situation. The biggest direct impact is on the dairy sector.
- Although the restrictive measures of the EU and other countries and Russia's import ban will have significant effects on the outlook of certain companies and sectors, their direct effects on the overall economic activity of Russia and its trading partners will be minor, however.
- The Economics Department of the Ministry of Finance forecasts that Russia's GDP will decline by 1% and its imports by 9% in 2014 and that growth will be zero in 2015. The Bank of Finland's Russia forecast to be published later will, as matters stand, be slightly brighter.
- According to Economics Department analysis, the cumulative direct impact of Russia's import ban on GDP will be around 0.1% and on unemployment very marginal. The weakening of Russia's growth will reduce Finland's total output in 2014–2015 by a total of around one half of one per cent and will increase the unemployment rate by the end of 2015 by around 0.2 percentage points relative to the December 2013 forecast. The effects are included in the forecast prepared as the basis for the budget proposal (to be published on 15 September 2014).
- According to Bank of Finland analyses, Russia's import ban will reduce Finland's total output in 2014 directly by around 0.1%; according to the Government Institute for Economic Research (VATT), the corresponding figure is 0.01%. When the general weakening of Russia's economic development is taken into account, the Bank of Finland estimates that the negative impact on growth will be around 0.2% this year.
- Even in the risk scenario – the Russian economy declines sharply from the second half of 2014 until 2016 and imports are reduced by around one third relative to their 2013 level – Russia's economic slowdown will have no decisive impact on the overall picture of the Finnish economy.

Summary

Russia's economic growth has slowed as a result of, among other things, the slow regeneration of the country's economic system. Persistently high oil prices will not bring the growth seen in years past, due to a lack of capacity and a low level of investment. Russia will therefore not succeed in the growth strategy typical to emerging economies, in which income based on inexpensive labour and abundant natural resources is invested in a manner that creates new growth based on higher value-added production. The weakening of the rouble began in summer 2013 after the Federal Reserve announced a possible future tightening of monetary policy. During the last six months, growing geopolitical uncertainty has raised interest rates in Russia, weakened the rouble, accelerated inflation, decreased investment and reduced imports.

While Western countries' economic sanctions and Russia's import ban will significantly impair the prospects of certain companies and sectors, their impact of the overall economic activity of Russia and its trading partners will be minor, however. The number of products subject to sanctions is limited. In addition, the Russian government and central bank may, for example, support the banking system, which has been targeted by sanctions, and thus maintain lines of credit.

The Ministry of Finance forecasts that Russia's GDP will decline by 1% and its imports by 9% in 2014 and that growth will be zero in 2015. According to this forecast, the weakening of Russian growth will reduce Finland's GDP in 2014–2015 by around one half of one per cent relative to the December 2013 forecast of the Ministry of Finance's Economics Department. The slowdown in activity resulting from this will raise the unemployment rate by around 0.2 percentage points by the end of 2015. The direct impact of Russia's import ban on GDP will be around 0.1% and on unemployment very minor. The Economics Department forecast to be published on 15 September 2014 includes within it the aggregate effects of the import ban.

The Bank of Finland's Russia forecast, which is based on more recent statistical data and will be published later, is according to preliminary information slightly brighter, if other factors impacting economic development do not deteriorate. According to the Bank of Finland's analyses, the import ban on certain foodstuffs, imposed by Russia in early August, will reduce Finland's GDP in 2014 by around 0.1%; according to the Government Institute for Economic Research (VATT), the corresponding figure is 0.01%. Taking into account the general weakening of Russia's economic development, the Bank of Finland estimates that the negative impact on growth will be around 0.2% this year.

In the risk scenario, in which the Russian economy declines sharply from the second half of 2014 until 2016 and imports are reduced by around one third relative to their 2013 level, Russia's economic slowdown will have no decisive impact on the overall picture of the Finnish economy. The cumulative additional contraction in GDP would be around 1% by 2016.

In terms of the impact of Russia's import ban, Finland's food exports to Russia are expected to decline to less than a quarter of the normal situation. The biggest direct impact is on dairy products. In 2013 dairy products accounted for over 80% of Finland's food exports to Russia. Other sectors affected by the ban include meat and fish.

As a result of the direct effects arising to food exports, pressure will be further directed to domestic agricultural production. Particularly in the dairy sector, the fall in sales might result in a decline in producer prices and a deterioration of profitability.

EU-imposed economic sanctions

Since March, the European Union has gradually tightened the restrictive measures directed at Russia as a result of the situation in Ukraine, firstly by deciding on asset freezes and travel constraints for a number of people and organisations. Later, access of Russia's state-owned financial institutions to the financial markets was restricted and EU citizens were prohibited from investing in bonds, stock market listings and other financial instruments of Russia's state-owned financial institutions.

In addition, the EU has imposed sector-specific constraints. The import and export of military equipment and the export of dual-use goods intended for military end-use are prohibited. Products going to the Russian army are considered automatically to be intended for military end-use. In addition, the export of a separate list of products used in Arctic, deep water and shale oil projects is prohibited. The purpose of the restriction is to intervene in the development of the sector in the long term, not to influence the current availability of oil. The EU also restricted the provision of technical assistance, brokering services and financing related to the aforementioned products and their export.

Russia-imposed import bans

On 7 August 2014, Russia imposed a ban on the importation from the EU, the USA, Canada, Australia and Norway of meat and meat products, milk and dairy products, root crops, vegetables, fruits and nuts, vegetable fat-based food products, fish and shellfish. The ban is valid for one year. Pork has already been the subject of an import ban in Russia since January due to African swine fever, which has spread into the area of the EU. The ban does not apply to imports by private individuals nor to products intended for children. Russia announced on 20 August 2014, that the import ban will not affect, among other things, lactose-free dairy products or seed potatoes.

The effects of sanctions on food production and agriculture

Finland's food exports to Russia in 2013 were valued at just over EUR 430 million. Of this, the dairy product company Valio accounted for around EUR 350 million. Cheese and cheese product exports are valued at EUR 128 million and butter at EUR 73 million. Yoghurt and other fermented milk products were exported to the value of EUR 21 million. The remaining exports, valued at EUR 80 million, is divided into several groups. Of meat products, the largest export item last year was pork, valued at EUR 12 million. Pork has already been the subject of an export ban in Russia since January. Russia has justified this ban through the incidences of serious animal diseases in EU countries.

The effects on food exports are directed at domestic agriculture and the food industry. Particularly in the dairy sector, it possible that producer prices will fall and profitability deteriorate throughout Europe as sales decline. In terms of both total turnover and export revenue, milk production is Finland's most import agricultural production sector. The milk product price pressures are affected, among other things, by the fact that, instead of the high value-added products exported into Russia, surplus milk must be processed into butter and milk powder, whose value added is significantly lower. The final impact will depend on the extent to which substitute export markets are found for higher value-added products.

In 2013 the total value of EU Member States' food exports to Russia was EUR 12.2 billion. Of this, foodstuffs valued at around EUR 5.3 billion subject to the imposed ban will in future be directed to the EU internal market, and market channels in countries outside the EU other than Russia will have to be found. This will also result in downward pressures on Member States' consumer food prices and correspondingly also on agricultural producer prices.

The effects of counter sanctions on other fields of business

Of the negative economic effects experienced by business, most will result from Russia's weakened economic situation and from the general uncertainty created by the Ukraine crisis. The sanctions directed at the financial sector by the EU, together with Russia's weak economic development, have tightened the financial situation in Russia and are particularly impacting sales of the Finnish technology industry's investment goods in Russia. In addition, the uncertainty increased by the Ukraine crisis is weakening the investment climate in Russia. Finland's exports of goods to Russia have fallen by 14% in the early part of the year (January-May).

Decline in demand for investment products in Russia will impact Finland's economy and exports more extensively than the import restrictions imposed by Russia on the food sector.

Consumption by Russians in Finland in 2013 totalled around EUR 1.210 billion, of which purchases accounted for EUR 908 million and services for EUR 301 million. Purchases accounted for around 2.0% of retail sector turnover subject to value-added tax. Demand for services is focused particularly in Helsinki and for purchases in South Karelia. Russian visitors' consumption per capita already began to decline last year, but visitor numbers still grew and total consumption also increased. The downturn in the consumption of Russian visitors began in summer 2013. As a result of the sanctions, Russians' shopping trips to Finland may pick up, but overall this will not have a significant impact.

The direct economic effects of restrictive measures and counter sanctions – assessment of the Economics Department of the Ministry of Finance

The sector-specific restrictions imposed by the EU will have very limited direct effects on Russia's economy overall. The sanctions will particularly reduce foreign investment in oil exploration and in unconventional oil resources.

Capital market restrictions will have limited direct effects on the Russian economy through Russian companies or banks subjected to restrictions. Both state-owned companies and almost all large state-owned banks have very low levels of foreign debt with a term of less than one year. The significance of financing in the Russian economy is smaller than in the developed economies. The restrictions would have a negative impact on the access to funding, costs and other terms of credit of all Russian companies and banks and on the Russian equity market.

In the short-term, it will be easy to compensate for difficulties in funding basic operations such as acquisition of assets. Companies and banks can use their liquid funds to repay debts.

In addition, funding can be obtained to some extent from other markets and from the domestic banking sector. Ultimately, the funding gaps can be filled by using Russian state funds as well as the central bank and state-owned banks.

Capital market restrictions will have no significant direct effects on Finland or on Finnish financial institutions.

Sector-specific restrictions are also directed at products in which trade between Finland and Russia is limited. Although the direct economic effects of sanctions on Finland are small, the effects may be significant for individual companies.

The import ban on foodstuffs covers over 30% of Russia's consumption of meat and vegetables and over 40% of its consumption of dairy products. In the short term, Russia will not be able to replace such imports with its own production or by importing, for example, from Asia and Latin America. The Ministry of Finance estimates that the import ban will increase food prices and accelerate inflation in Russia in 2014 by around 2 percentage points.

In terms of the impact of Russia's import ban, Finland's food exports to Russia will decline to less than a quarter of the normal situation. In 2013 Finland exported to Russia products subject to the import ban valued at around EUR 280 million. The biggest impact is on dairy products. The impact on food exports is directed at domestic agricultural production and the food industry, particularly the dairy sector. Moreover, the amount of foodstuffs subject to the import ban in the EU as a whole will in future be redirected into the internal market and substitute markets will have to be found.

On the other hand, the redirection of Russian imports may open up new export opportunities. The export of dairy products to Russia may be replaced by sales of butter and milk powder elsewhere or to an EU intervention fund. It is estimated that this will reduce the dairy sector's export income by EUR 50–100 million. Although the export ban will strongly impact certain companies, its overall economic effects will, however, even in the worst case, be very limited. According to a Ministry of Finance analysis, Russia's counter sanctions will reduce Finland's 2014 GDP by only around 0.1% at most.

The direct economic effects of restrictive measures and counter sanctions – assessment of the Bank of Finland

The economic sanctions relating to financing channels decided by the EU on 29 July 2014 have affected financing costs in Russia, but have not to date weakened the value of the rouble. Currently-decided restrictions on the export of military technology, dual-use products and certain technical products in certain fields will reduce the value of Russia's imports directly by only around 0.15%. At the same time, Finland's exports to Russia in these product groups are limited.

Foodstuffs subject to counter sanctions accounted for around 0.5% of goods exports in 2013 and around 0.4% of all exports. Foodstuffs subject to counter sanctions accounted for around 20% of all food exports in 2013. According to the 2010 input-output table, exports accounted for around 13% of the total value added in the food industry, so 2.6% of the food industry's production is looking for new markets. The ultimate impact of Russia's counter sanctions on total output will depend on the adjustment of production and the market to the new situation.

Market adjustment to the contraction of the export market caused by counter sanctions was assessed using the Bank of Finland's Aino model. Russia's counter sanctions will cut Finland's export demand by around 0.4%. As the counter sanctions affect all EU countries, oversupply of food will bring down prices across the EU. Based on this, it is assumed that Finland's relative export prices and price competitiveness will remain unchanged in the calculation. If it is also assumed that no substitute markets will be found quickly for the products, the changes in export demand will reduce Finland's exports almost in full.

The export flexibility of imports is crucial when assessing the impact of counter sanctions on GDP. If it is assumed that the food industry uses mainly domestic raw materials in its export products, the contraction of exports will not be transmitted significantly into raw material imports and Finland's net exports will contract to the same degree as the contraction of exports. The impact of Russia's counter sanctions on GDP will accordingly be slightly more than 0.1%.

If it is assumed that raw material imports will react to changes in export demand in full, the impact on total output will be smaller, less than 0.1%. in addition, if the oversupply of foodstuffs created by the contraction of the export market is released into the domestic market, consumer prices will fall and growth of domestic demand may compensate for a small part of the contraction of exports. It is also probable that food production will not contract to the same extent as Russian demand, because at least part of the production may be directed to other areas and processed into different products.

This calculation does not assess the spillover effects of the EU-imposed sanctions and Russia's counter sanctions on global, and particularly European, export markets. Knock-on effects possibly transmitted from these markets would further impact Finland's economy negatively. The effects of Russia's current counter sanctions across the EU may remain low, however, in which case the spillover effects on Finland will also remain small in scale.

The indirect effects of the sanctions – assessment of the Economics Department of the Ministry of Finance

The indirect economic effects of the EU's sanctions are more significant than the direct effects. The restriction of financing in particular may cause substantial indirect effects, as foreign banks begin to restrict Russian companies' access to financing.

The biggest impact will arise from increasing uncertainty. Russian and foreign companies and financial actors as well as Russian households may quickly move capital out of the country or the rouble. As a result, the rouble will weaken, which will fuel inflation and slow growth of consumption. In addition, caution will increase among real economy investors. The impact of the import ban imposed by Russia will be to increase food prices and further accelerate inflation, which will reduce consumption.

A weakening of the rouble, consumption and investment will reduce Russia's goods imports and travel by Russians abroad. These indirect effects will be directed via trade channels and exchange rate reaction to Russia's trading partners, depending on the closeness of economic relations. The lower activity of Russia's trading partners will be further reflected in Finland's export demand, but the impact on Finland's exports will be very small.

In 2013, Finland's goods exports to Russia amounted to EUR 5.4 billion, and imports from Russia totalled EUR 10.5 billion. Goods exports to Russia accounted for around 9.6% of the total value of exports and goods imports around 18% of the total value of imports. Russia is also a major export destination for services. For example, about 30% of tourists come from Russia and in 2013 they brought over EUR 1.2 billion in revenue to Finland.

In Russian exports, the share of domestic value added was higher than in exports on average. Domestic value added pays for wages, profits and taxes, and the share of domestic value added better describes a country's dependence on the export country's development than the share of gross exports. In addition, in Russian exports the proportion of SMEs is significantly higher than in exports on average. SMEs are less able to prepare for risks and to direct their efforts to new markets than large companies, in which case the effects of negative shocks may be more extensive.

The aggregate economic impact of sanctions is included in the forecast of the Economics Department of the Ministry of Finance to be published on 15 September 2014.

Russia's economic situation – assessment of the Economics Department of the Ministry of Finance

The occupation of Crimea and its incorporation into Russia in late February-early March, Russia's actions in Eastern Ukraine to destabilise the situation, the threat of sanctions and the negative development of Russia's domestic and economic policy have increased the uncertainty surrounding Russia. Russia's economic growth halved from around 2% in the final quarter of last year to just over 0.8% in the first and second quarters of this year. The Economics Department of the Ministry of Finance forecasts that Russia's GDP will decline by 1% in 2014 and will remain at this level in 2015.

Although the increased geopolitical uncertainty has raised interest rates in Russia, weakened the rouble, fuelled inflation, lowered investment and reduced imports, the situation in Ukraine as well as the sanctions and counter sanctions contribute only partly to Russia's economic challenges. Growth has slowed above all as a result of the slow regeneration of the country's economic system. Even persistently high oil prices will not bring the growth seen in years past, due to a lack of capacity and a low level of investment.

According to the Economics Department's assessment, the weakening of Russia's economic outlook will reduce Finland's total output in 2014–2015 by a total of around one half of one per cent and will increase the unemployment rate by the end of 2015 by around 0.2 percentage points relative to the December 2013 forecast. The cumulative impact of Russia's import ban on GDP will be around 0.1% and on unemployment very marginal. These calculations include large uncertainties, particularly in a situation in which economic policies might change.

Russia's economic situation – assessment of the Bank of Finland

According to a Bank of Finland forecast published in June, Finland's economy will remain on the 2013 level in 2014. In terms of Russia's economic development, the underlying assumptions of the forecast include the slowing of Russia's economic growth observed in the spring, the weakening of the rouble and the growth of uncertainty caused by the Crimea crisis. The baseline scenario of the June forecast does not include the effects of a possible escalation of the crisis from the then prevailing situation.

Russia's economic growth began to weaken during 2013. Russia's growth forecast for 2014 was adjusted downwards in December 2013 by around 2 percentage points and Russia's import forecast by around 5 percentage points. This weakening that took place in Finland's export market can be estimated to reduce Finland's economic growth by around 0.1% in 2014.

Economic growth in Russia during the spring and summer has again given cause to change Russia's import forecast downward. If Russian imports contract this year by 6% from the previous year, and the value of the rouble remains at its current level, it can be expected that Finland's GDP growth in 2014 will be 0.2% slower than in the Bank of Finland's June forecast.

Russia's counter sanctions – analysis of the Government Institute for Economic Analysis (VATT)

The VATTAGE model can be used to assess in detail the effects of Russian import shocks on the Finnish economy. In the scenario, the percentage decline in exports of agricultural products and foodstuffs caused by the sanctions is reflect directly in exports outside the EU. The sanctions on agricultural products and foodstuffs alone will not have a significant impact on the size of Finland's GDP, even when one takes into account that extra production cannot be directed as higher exports to other EU countries. The counter sanctions will, however, cause changes in the relative prices of foodstuffs and agricultural products and will be evident on the sector level as more significant impacts than on the level of the economy as a whole.

In the scenario, GDP will grow by no more than 0.01% less than in the baseline scenario. In addition to the impact on exports, the main reason for the fall in GDP is a decline in investment. The reduction in food exports will be evident in a decline in the domestic price level of foodstuffs, which will slightly reduce food imports and be apparent as a positive impact on GDP caused by the reduction of imports. This effect will be smaller if the price level of imported foodstuffs falls, in which case the overall impact of the counter sanctions on GDP will be slightly greater. The impact of the counter sanctions on the EU price level of foodstuffs will, however, remain fairly small, according to an assessment made using the GTAP model, which examines global trade.

In those sectors in which the sanctions are targeted directly, the effects will clearly be greater. For example, in the food industry, the sanctions are expected to reduce employment by around 3.8% and value added by around 2.5% cumulatively by 2015. Except for exports to EU countries, fisheries' exports have been directed almost exclusively to Russia in recent years. As a result, the effects on the value added and employment of fisheries are also almost as great in percentage terms as on the food industry. The sanctions will not affect agricultural exports as much in relative terms, and the effects on agriculture will be smaller than on the food industry or the fisheries. The effects on the value added and employment of sectors other than those mentioned will be very small. For example, the value added of goods transports by road is expected to fall by at most 0.2% compared with the 2015 baseline scenario, and a few other export sectors will even benefit minimally from a slowing of the rise in costs in Finland and from export growth in the sectors in question.

Risk scenario

The Economics Department of the Ministry of Finance has also prepared a risk scenario examining the effects in Finland of a dramatic decline of the Russian economy. In the scenario, Russia's import volume decreases by the end of 2016 by a total of around 32% from the 2013 level. Imports are cut by a weakening of general economic activity, a reduction in purchasing power through currency devaluation, and declining exports of Russian oil. Around 10% of Finland's exports are directed to Russia. The weaker development than expected of Russian imports assumed in the scenario would be reflected with this weighting in Finnish exports. In addition, the weakening of Russia's economic activity would also affect Finland via Russia's trading partners, but this impact on Finland's export demand will be quite limited.

In the calculation, it is assumed that Finland's imports will weaken to the same degree as GDP growth. The impact on imports could be slightly lower, because in food production the significance of imported foreign inputs is lower than usual compared with many other sectors. As the development of total output weakens, demand for labour will also be more modest than previously anticipated. The calculation also assumes that half of the change in GDP will be reflected in employment. In this case, productivity development will be slightly faster than assumed in the baseline forecast, because weakening of employment will be more cautious than development of total output. In industry, changes in output are typically not fully reflected in employment.

The calculation further assumes that the weakening of Finland's exports would not be reflected in domestic actors' investment and consumption decisions. A deterioration in the employment situation would, however, inevitably increase the risk that consumers might become slightly more cautious in their behaviour. Similarly, companies might wish to postpone some investment projects relating to trade with Russia.

The main results of the risk scenario are presented in Table 1. The figures are in relation to the baseline scenario of the forecast of the Economics Department of the Ministry of Finance to be published on 15 September 2014. The key message of the analysis is that an improbably dramatic downturn in Russia's economy would weaken Finland's GDP cumulatively by 2016 by a total of around 1% compared with the forecast's baseline scenario.

TABLE 1. Difference of forecast and risk scenario

	2013	2014	2015	2016
	%-change			
GDP	0,0	-0,2	-0,5	-0,3
exports	0,0	-0,7	-1,8	-0,8
imports	0,0	-0,1	-0,4	-0,2
employment	0,0	-0,1	-0,3	-0,1
productivity	0,0	-0,1	-0,3	-0,1
unemployment rate	0,0	0,1	0,2	0,3
Russian imports	0,0	-8,1	-12,9	-6,8

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