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Russia: Western Sanctions and Eastern Escape Routes

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Hit by trade and financial sanctions following its invasion of Ukraine, Russia has shown relative resilience. Its trade declined during 2022, but at the end of the year, thanks to India and China, exports remained above their 2019-2021 average, while on the import side, it was essentially China that replaced Europe as Russia's supplier. However, Chinese exports offered only limited compensation for sanctioned European exports to Russia. Turning to the financial sphere, China has enabled Russia to suffer less from the sanctions, thanks to the growing role of the yuan.

The sanctions imposed on Russia following its invasion of Ukraine are designed to impose "*severe consequences on Russia for its actions and to effectively thwart Russian abilities to continue the aggression*" (European Commission). Cut off from financial flows with the "Western" world and its close allies, and hit by trade restrictions, the Russian economy nonetheless showed relative strength in 2022. This reflects the rapid geographical reallocation of its foreign trade and its preparation for sanctions, with the implementation of numerous bypass circuits and a clear pivot towards India, Turkey and, above all, China.

Russian trade: the Asian shift

In 2022, Russia recorded a trade surplus of $284 billion with its main trading partners.[1] However, this considerable surplus – +$156 billion compared to that in 2019 (+122%), +$124 billion compared to 2021 (+77%) – masks trends in Russian trade since the war in Ukraine. The trade surplus, which reached almost $33 billion in March and April 2022, has narrowed considerably since then – $14 billion in December (Figure 1.a) – but remains higher than the monthly average between 2019 and 2021 ($10 billion).

Under the combined effects of higher energy prices and the gradual increase in sanctions, Russian exports, after rising at the start of the year, began a gradual decline from April 2022 onwards (Figure 1.b). However, thanks to the reorientation of its trade towards non-aligned countries – those that did not impose sanctions against it following the invasion of Ukraine – Russia was able to preserve higher revenues than those recorded on average between 2019 and 2021. While exports to the aligned countries represented $10 billion in December 2022, less than 2/3 of the pre-2022 average ($16 billion on average between 2019 and 2021), rising exports to India (+$4 billion), China (+$3 billion) and Turkey (+$2.6 billion) more than made up for this loss.

On the import side, the massive drop in the wake of the Ukraine invasion, from $18 billion to $8.5 billion between February and April 2022, was followed by a slow recovery in the last quarter of 2022 to the average monthly level observed over the 2019-2021 period, thanks to non-aligned countries, mainly China. In December 2022, the latter supplied 52% of Russian imports, compared with an average of 27.6% over the 2019-2021 period, offsetting the fall in imports from aligned countries, mainly the European Union (EU), whose share in Russian imports was down to 24% in December 2022, compared with an average of 48% over the 2019-2021 period.

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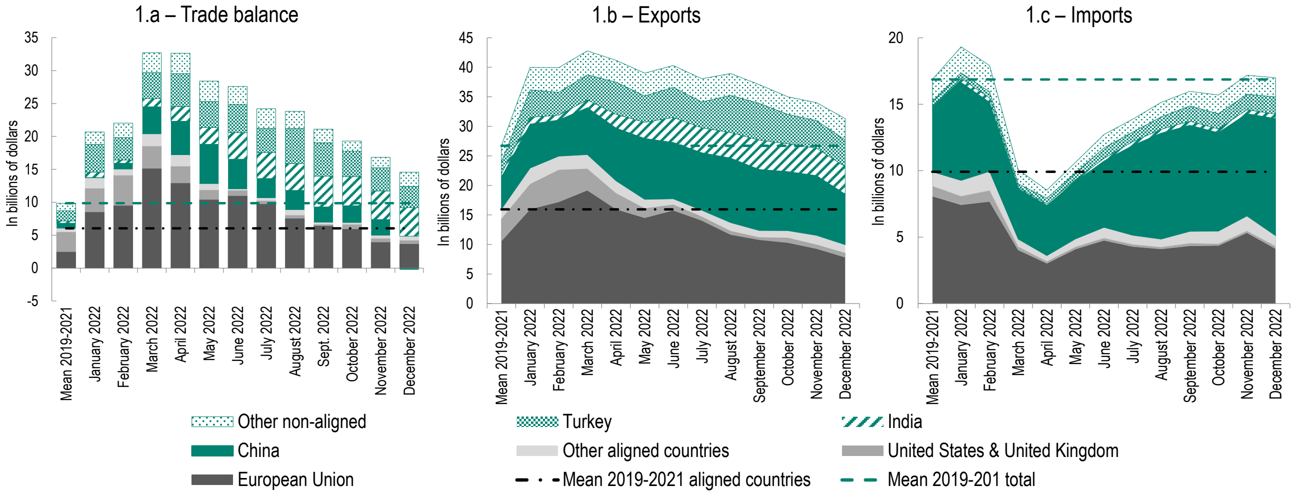
1. Due to the biases in natural gas trade data, the trade in goods considered here excludes them (see Bellora *et al.*, 2022). In addition, due to data availability and quality, Russia's trade with 53 countries representing 80% of its exports and 82% of its imports of goods in 2019 is taken into account.

Figure 1 – Reallocation of Russian foreign trade to non-aligned countries



Note: "Aligned countries" are those that applied trade sanctions in 2022 against Russia; "non-aligned" countries are those that did not adopt sanctions.
Sources: Authors' calculations based on Eurostat, Comext database, United Nations, UN Comtrade database, and South Korean Customs Service.

Ultimately, India, China and Turkey provided outlets for Russian exports, while China replaced the aligned countries, essentially Europe, as Russia's supplier. It remains to be seen how petroleum products, the mainstay of Russian exports and gradually targeted by sanctions, have contributed to this trend, and to what extent imports from China have offset imports of sanctioned goods.

China and especially India: the new destinations for petroleum products

Accounting for 52% of its exports in 2022, petroleum products earned Russia $238 billion (net exports) over the year. Despite increasing restrictions on these products, aimed at weakening its export revenues and making the war effort more difficult, Russia took advantage of rising energy prices, in a context of post-health crisis recovery, and of international fragmentation regarding the sanctions to be adopted in response to its aggression, to maintain and even increase its oil revenues (Figure 2).

From March 2022 onwards, due to the rapidly implemented embargoes, flows to the US and the UK declined, reaching negligible quantities by May, while the EU – a little more slowly – reduced its imports (from around $12 billion in March to $6 billion in December 2022). However, China, India and, to a lesser extent, Turkey saw their imports increase. The most striking case is that of India. Being a minor destination, averaging $190 million per month over the period 2019-2021, India increased its imports of Russian oil products more than tenfold in 2022. China also increased its imports from March onwards, from around $4 billion a month to an average of $6 billion from May onwards.

With imports averaging $9.4 billion a month since May 2022 (compared with an average of $3.4 billion over the 2019-2021 period), China and India have provided substantial income for Russia, offsetting the losses recorded from June onwards with the aligned countries – at least until December 2022 and the downturn in Chinese imports. Moreover, with China and India geopolitically out of reach of possible sanctions (in retaliation for the alternatives they provide Russia with) and India positioning itself as a hub for refining Russian crude oil, Russia has found, for the moment, not just a respite but a real escape route. This reorientation of Russia's trade represents a financial windfall for India, which makes considerable margins by sourcing low-cost crude oil and then re-exporting refined products at market prices, including to countries applying sanctions. India's exports of refined petroleum products have jumped by 75% in one year, to reach $94 billion in 2022, with the United States accounting for $5.6 billion (*i.e.* an increase of 38% compared to 2021) and the EU for $5.8 billion (+109%).[2]

The deceptive resilience of imports

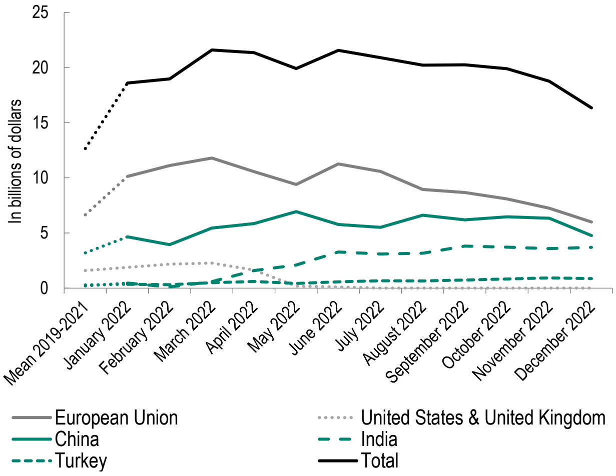
Alongside restrictions on the imports of petroleum products from Russia, several rounds of sanctions have also targeted or even prohibited exports of a number of products to Russia, to prevent it from obtaining supplies of goods deemed strategic.[3]

As we have seen, thanks to China, Russian imports have proved resilient. However, to assess the extent of China's

2. Heading code 10 of Chapter 27.
3. These include military equipment, key goods and technologies for a number of industries (energy, communications, aviation and space), certain types of machinery and transport equipment, cutting-edge technologies (advanced semiconductors, electronic components), and that can be used exclusively for civilian purposes (luxury goods) or for dual use (drones).

Figure 2 – Exports of petroleum products diverted to India and China

Russian exports of petroleum products

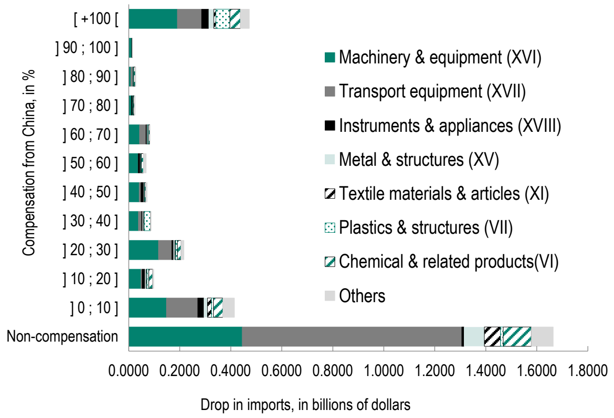


Note: This graph covers heading codes 09, 10, and 11 of Chapter 27 of the harmonized system.

Sources: Authors' calculations based on Eurostat, Comext database, United Nations, UN Comtrade database, and South Korean Customs Service.

Figure 3 – China's compensation for sanctioned imports remains limited

Reductions in imports from the European Union affected by sanctions, according to the compensation rate applied by China



Reading note: The drop in imports from the EU due to sanctions for which China provides compensation between 0 and 10% (interval]0; 10] on the graph) amounts to $414 million; those for which China provides compensation between 20 and 30%, to $216 million.

Sources: Authors' calculations based on Eurostat, Comext database, United Nations, UN Comtrade database, and South Korean Customs Service.

substitution regarding sanctioned European products, it is necessary to analyze the offsets that have been made at the finest possible level.[4] China may indeed have increased its exports of certain sanctioned products by more than the drop in European exports of these products to Russia, but may have done little for other products, with the result that the variation in Chinese exports does not reflect the reality of the substitution. This is, in a way, what we observe: on more than $2 billion of import declines from the EU (on average per month before and after the sanctions; last two bars at the bottom of Figure 3), compensation was less than 10% (including $1.7 billion without compensation), while it was only greater than 80% for $515 million of import declines, including $473 million with overcompensation. Thus, while China was the main country to compensate for the drop in imports from Europe due to sanctions, less than 24% was compensated for.[5]

Particularly hard hit by the sanctions, imports of transport equipment from Europe, down by over a billion dollars (monthly average), were only marginally offset by China: almost 3/4 of the drop in these imports was not offset at all. In particular, China struggled to offset declines in imports of goods associated with air, space, and sea navigation. On the other hand, it (over)compensated for specific categories of goods and passenger vehicles. For imports of machinery and equipment, which have also fallen by a billion dollars a month on the European side, China's compensation is better: only 39% of this fall is not compensated for, and 20% is at least compensated for up to 70%.

De-dollarization in favor of the yuan

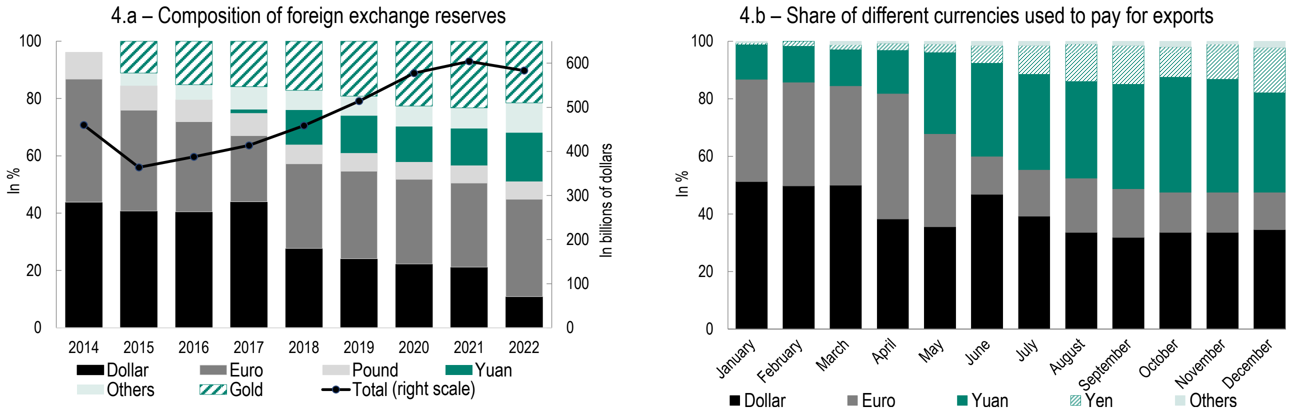
While China has only partially contained the effects of trade sanctions, due to limited substitution, it offers Russia ways of circumventing financial sanctions.

One of the critical sanctions was the exclusion of the main Russian banks from the SWIFT (Society for Worldwide Interbank Financial Telecommunication) system. This exclusion greatly complicates transactions between banks, as well as fund transfer orders and orders to buy and sell securities.

Faced with this sanction, Moscow has highlighted the advantages of its own financial messaging system (SPFS) and raised the possibility of integrating the Chinese cross-border interbank payment system CIPS. However, while the Russian system works well at the national level, it does not allow Russian banks to be connected internationally. Furthermore, as CIPS is connected to SWIFT, massive Russian adoption of the Chinese system would expose Chinese banks to the risk of secondary sanctions from Western countries. This makes bypassing the SWIFT system tricky, even if some thirty Russian banks have recently taken the plunge and joined the Chinese system. Alongside the exclusion of the main Russian banks from SWIFT and the prevention of Russia from accessing EU financial markets, a third key sanction has been the freezing of part of the Russian Central Bank's international reserves ($643 billion by February 2022) to prevent it from supporting its currency.

4. For a methodological description, see the notes associated with the graph in the online companion file.
5. Turkey accounts for 8%, while the other non-aligned countries together account for less than 5%.

Figure 4 – Diversification of international reserves and de-dollarization of the Russian economy in 2022



Note: For 2014, the precise breakdown of reserves in gold and currencies other than the dollar, euro and pound is unknown.

Source: Central Bank of Russia.

However, after depreciating sharply against the dollar following the outbreak of conflict and sanctions in February 2022, the ruble quickly returned to its pre-war level, reaching 54.5 rubles to one dollar in June 2022, a level not seen since 2015, at a monthly average[6]. One reason is the evolution and composition of the central bank's reserves (Figure 4.a). While the dollar's share in reserves stood at 44% in 2014, it fell to 11% in 2022.

Indeed, since the sanctions linked to the annexation of Crimea in 2014, Moscow has not only strongly accumulated reserves, but also diversified its foreign assets by transferring a significant portion to yuan and gold: 22% of reserves were held in gold, and 17% in yuan at the end of 2022 (Figure 4.a). Unlike in 2014, the central bank had therefore prepared for the restrictions before the invasion of Ukraine, by "de-dollarizing" its foreign exchange reserves, enabling it to circumvent, in part, the effects of Western financial sanctions in the short term.

This de-dollarization was made possible thanks to India, the world's third-largest importer of crude oil, which has become Russia's main supplier, and to China. Since the oil sanctions came into force on December 5, 2022, India has been paying for its purchases of Russian crude oil in currencies other than the dollar, such as the UAE dirham and the ruble. Similarly, Moscow recently authorized China to pay for its gas purchases in yuan and ruble.[7]

This shift affects all Russian exports (Figure 4.b). Before the invasion of Ukraine, over 60% of exports were denominated in the currencies of aligned countries, such as the dollar and the euro, while the yuan accounted for less than 1%. Today, the yuan accounts for 16% of export payments, while the share of the dollar and euro has dropped below 50%.

Overall, the evolution of trade and the ruble exchange rate shows that an *immediate* collapse of the Russian economy due to Western sanctions should not be expected. Their effects will have to be seen over a longer horizon since, by making the war effort more difficult for Russia, they are likely to have a long-term impact on the economic, financial, and technological spheres. These effects are already beginning to be felt, with the ruble depreciating by around 30% since the beginning of 2023 – particularly marked since late spring – notably due to the financial burden of the war, coupled with the drop in oil revenues as a result of the sanctions that came into force at the end of 2022.

6. The dollar rose from 82.7 rubles on February 25, 2022 to 146 rubles on March 7, 2022, an appreciation of over 80% in seven days.

7. These were the measures taken on June 3, 2022 by the European Council in its sixth sanctions package: *(i)* a ban on the purchase, import and transfer of crude oil transported by sea and of certain petroleum products from Russia, and *(ii)* a ceiling on the price of crude oil imported by sea.

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