BLOG

G7 countries prepare to discuss Russia trade sanctions

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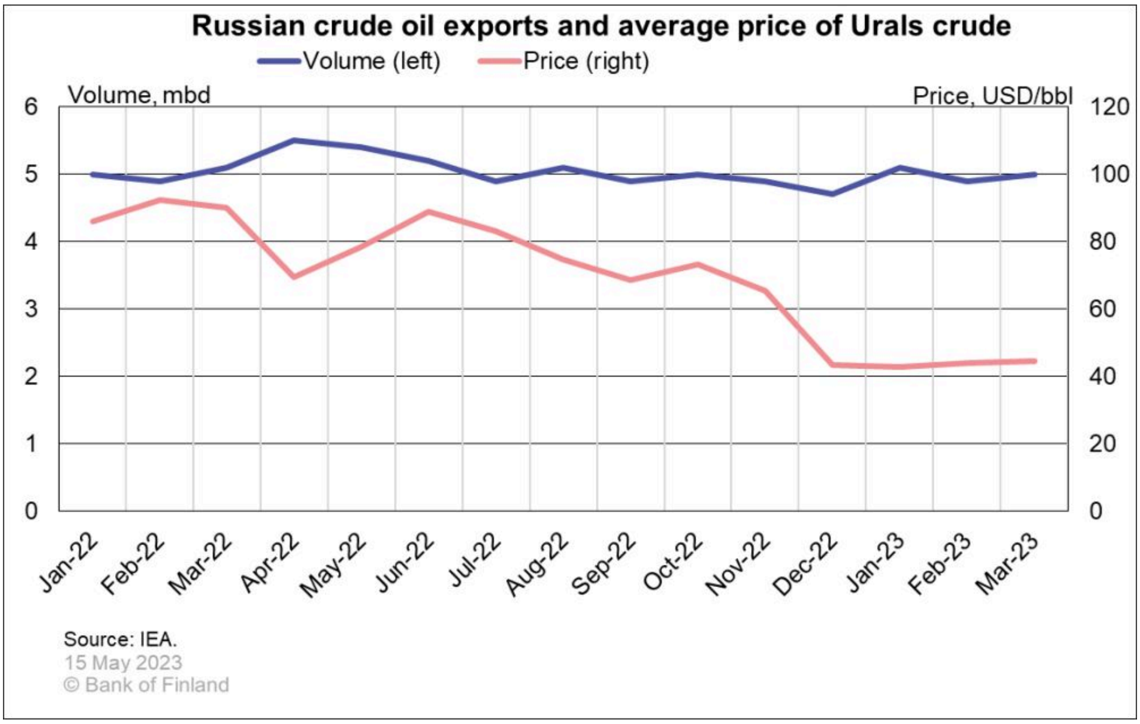
A wide coalition of countries have imposed economic sanctions on Russia for its brutal aggression against Ukraine. The sanctions regime has impaired – but not exhausted – Russia's financial and technological ability to make war. Discussion on intensifying the sanctions is set to be on the agenda at this week's G7 summit in Japan, including restrictions related to Russia's oil exports and technology imports.

The G7 and the EU imposed a price cap mechanism on exports of Russian crude oil in December 2022. This was extended to petroleum products in February 2023 to complement corresponding EU import bans that entered into force at the same time. The mechanism is designed to avoid substantial distortions in the global oil market by letting Russia shift its oil exports away from the European market, while maintaining a price cap that limits Russia's earnings oil exports.

The current price caps are USD 60 per barrel for Russian crude oil, USD 100/bbl for premium petroleum products and USD 45/bbl for discounted products. The cap levels can be revised periodically as needed. In practice, the price cap mechanism allows provision of transport, insurance, financial and related services for shipping Russian oil only when the price at which the oil is sold does not exceed the cap. These service markets are dominated by companies based in European countries that currently participate in enforcement of the price cap mechanism.

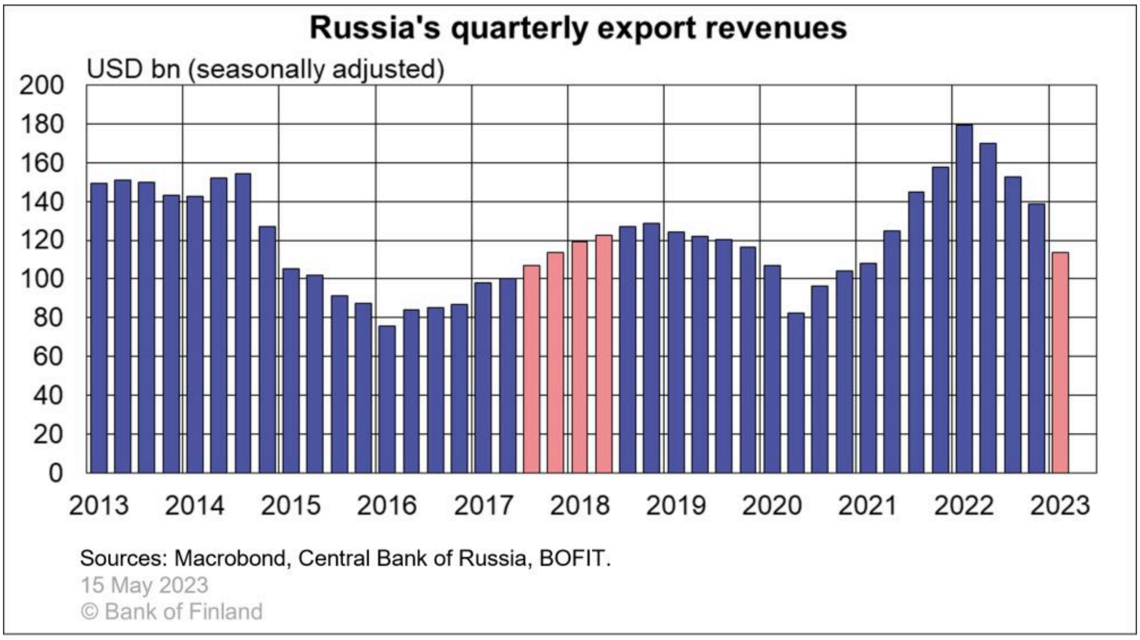
The experience of recent months suggests that the consequences of EU import bans and price cap mechanism have been largely in line with intentions. As shown in Figure 1, the volume of Russian crude oil exports has remained stable, while the price of Urals-blend crude has fallen substantially more than crude prices of other producers. The IEA found that the average Urals price was down about 50 % y/y in 1Q23, while the price of Brent crude was only down 20 %. The weighted average price of Russian crude exports (Urals and ESPO grades) was about USD 52 per barrel in January-March 2023. Developments were similar for various petroleum products.

Chart 1.



Russia's export earnings have declined sharply over recent past months with falling oil prices. The value of Russia's goods exports was USD 100 billion in 1Q23, down 35 % y/y according to preliminary figures released by the Central Bank of Russia. If Russia's oil export volumes remain stable and the average export price stays at the current level (i.e. below the USD 60 price cap), Russia's export earnings are likely to stay roughly unchanged in coming months. The value of Russia's exports in 1Q23 corresponds to the 2017–2018 average (Figure 2).

Chart 2.



Oil & gas production and exports are major revenue streams for Russia's federal budget. In 2022, oil & gas revenues accounted for over 40 % of total federal budget income. The income mainly consists of taxes on oil production, which in turn is based on the prevailing price of Urals crude. To mitigate effects of a lower Urals price on budget income, the tax is now calculated on the basis of a fixed discount relative to Brent crude price (USD 34 per barrel in April 2023 and gradually declining to USD 25 from July 2023). Russia's budget plan for this year assumes an average Urals price of USD 70 per barrel. A lower average price would expand the budget deficit or force the government to implement spending cuts.

Media reports also mention discussion among the G7 countries and within the EU on expanding the coverage of restrictions imposed on exports to Russia and additional control measures to prevent sanction evasion. According to the European Commission, export restrictions currently apply to about half of the EU's goods exports to Russia in 2021.

Several studies suggest that Russia has generally had limited success in finding substitutes for sanctioned import goods, so sanctions have restricted Russia's access to foreign technologies.[1] Even when Russia does find substitutes from countries outside the sanctions regime, their quality is typically inferior and price higher. Even so, there is evidence of schemes to skirt sanctions, implying that the effects of sanctions face a risk of dilution down the road.[2] Robust measures for tackling sanctions evasion are critical at this juncture in assuring the effectiveness of the sanctions regime.

Extension of export restrictions, which currently are quite narrowly defined, might also help curb sanctions evasion. Indeed, certain studies point to potential sanction evasion simply by utilizing customs codes not subject to restrictions. More comprehensive export restrictions would likely increase the costs arising from sanctions for Russia, and recent studies suggest that extending export restrictions could have a significant negative impact on the Russian economy.[3]

For countries already participating in sanctions, the impact of more extensive export restrictions is likely to be quite limited. Russia's importance as a trading partner has substantially diminished for the sanctioning coalition. Indeed, for most EU countries, Russia accounted for less than 1.5 % of their total exports in December 2022.

Russia has also become a substantially riskier and more hostile market for foreign companies. A Russian duma representative has recently proposed to put on all products from Western countries a label "Made by Russia's enemies". Russia has introduced additional corporate taxes to finance the budget deficit and legislative changes now permit officials to oblige practically any company to participate in the war effort and even seize their assets. Even longer-term perspectives for Russia as an export market are becoming gloomier every day Russia continues the war. The war and sanctions are casting long shadows over the Russian economy.

Key words

BOFIT, Russia, sanctions, trade, Ukraine