

EU trade and investment following Russia's illegal invasion of Ukraine



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BRIEFING

EU trade and investment relations with Ukraine and with Russia before Russia's illegal invasion of Ukraine in 2022

ABSTRACT

This briefing offers a short overview of EU's trade and investment relations before the start of the full-scale Russian invasion, highlighting the asymmetries in these relations, the shifting trade patterns of Ukraine and Russia, the economic structure of the two countries, and the EU's dependencies on Russia. This is followed by an overview of existing bilateral investment and trade agreements between the EU and the conflict parties and the process of Ukraine's approximation and accession to the EU.

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Executive summary

Trade and investment relations

- The trade relationships between the EU and both Ukraine and Russia were asymmetric. Both countries accounted for a small share of EU exports but imported a large proportion of their goods from the EU. Furthermore, the EU was the main export market for both countries, and they mainly exported commodities to the EU.
- In the past decade, Ukrainian imports shifted away from Russia and towards the EU and China, while Russia increased its imports from China and decreased its dependency on the EU. Still, before the war the EU remained Russia's main trading partner.
- The EU is the primary foreign investor in both Russia and Ukraine. However, only roughly half of EU FDI into Russia and Ukraine ultimately comes from EU countries. Russian and Ukrainian investors seem to be using the EU as a vehicle to invest in their own countries.

Economic structure

- In 2019, affiliates of EU27 companies employed roughly 1 % of the labour force in both Russia and Ukraine, but generated a turnover of about 19 % of GDP in Ukraine and 10 % of GDP in Russia, although these shares are likely understated. The large-scale withdrawal of EU affiliates from Russia since the outbreak of the war will likely have a significant adverse impact on the Russian economy.
- Russian exports are dominated by mineral fuels and hence disruptions in the exports of mineral fuels can potentially have adverse effects on the Russian economy.
- Ukrainian exports have traditionally been more diversified than Russian exports, with both various food commodities and material manufactures playing a prominent role. Since the war, Ukrainian exports became more concentrated on food commodities, while the destruction of manufacturing facilities due to the war limited manufacturing exports.

Dependencies

- Russia is a major source of several critical raw materials (CRMs) for the EU. In particular, replacing Russian-sourced nuclear fuel with alternatives is challenging. Russia also provides significant shares of EU imports of palladium, tungsten, phosphate, nickel and copper.
- Russia and Ukraine also supply 'rare gases' (e.g. neon, krypton and xenon) to the EU. Supplies of such gases were disrupted by the war. The use of EU reserves, substitution with alternative gases, and obtaining new suppliers meant that there were no major disruptions despite a temporary surge in prices.
- Given that most exports from Russia and Ukraine are commodities, the war-related disruptions of production and exports were reflected in higher prices for European industries and not in the breakdown of their supply chains.

Bilateral treaties

- The EU and Russia had a Partnership and Cooperation Agreement (PCA) since 1997, but this does not include preferential trade access. EU-Russia trade relations are primarily governed by WTO rules.
- There are 23 bilateral investment treaties (BITs) between EU countries and Russia. Given the large number of expropriations that have taken place in Russia since the outbreak of the war, it can be expected that investors will seek compensation for them under investor-state dispute settlements in Russian BITs.

- At the outset of the war, the EU and a group of like-minded countries suspended the Most Favoured Nation (MFN) treatment from which Russia benefited as a member of the World Trade Organisation. While Australia, Canada, the United Kingdom and the United States introduced extra tariffs on Russian goods, the EU did not impose non-MFN tariffs.
- The main EU treaties with Ukraine are the 1994 Partnership and Co-Operation Agreement (PCA) and the 2014 Association Agreement (AA). The AA includes a Deep and Comprehensive Free Trade Area (DCFTA) agreement, which was provisionally applied since 2016, and both the AA and DCFTA were officially ratified and came into force on 1 September 2017.

Ukraine's accession process to the EU

- Ukraine became an EU candidate country on 23 June 2022. Opening negotiations is dependent on Ukraine fulfilling the seven opening benchmarks set out by the European Commission, which cover a range of issues from constitutional court reform and judiciary reform to anti-oligarch reform and legislation on minorities.

The DCFTA has succeeded in implementing trade-related reforms in public procurement, competition and countering technical barriers to trade, while challenges remain in transport, the financial sector and customs reforms. Issues outside of the DCFTA had limited progress, including corruption, rule of law, and oligarchic influence. Seven out of the 26 chapters of the AA have been identified as areas where Ukraine needs to make big improvements.

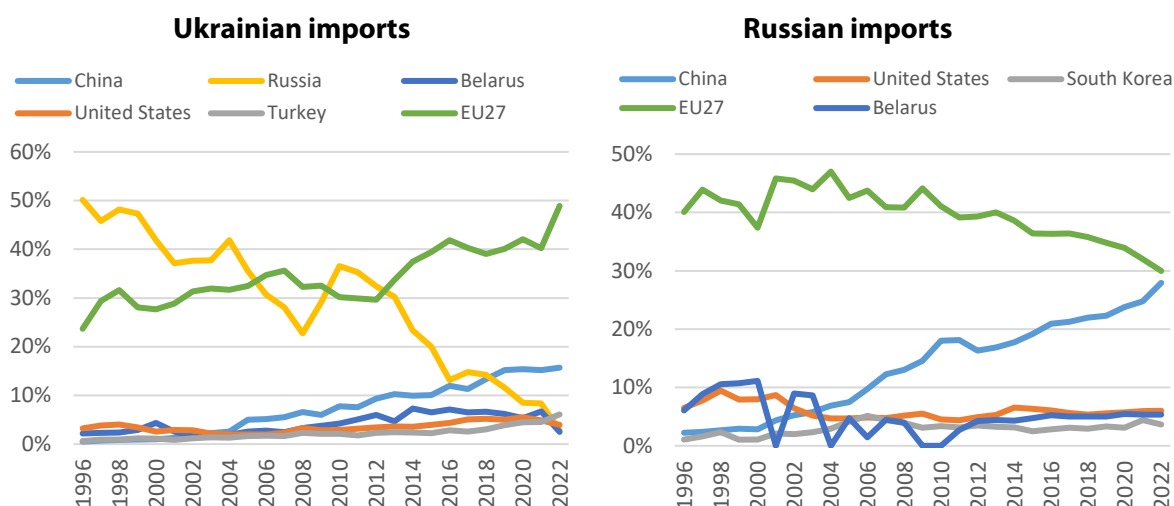
1 Introduction

The full-scale Russian invasion of Ukraine has disrupted trade between the European Union (EU) and Ukraine as well as upended the economic relationships between Europe and Russia. In this briefing, we will provide an overview of the trade and investment links between the EU and both Ukraine and Russia prior to Russia's invasion of Ukraine, as well as the institutional arrangements that were underpinning these economic relationships. This will provide the background to a discussion of the disruption of EU-Ukraine and EU-Russia trade links that will be discussed in one of the other briefings that are part of this series.

2 The European Union's trade and investment relations with Russia and Ukraine

2.1 Foreign trade

Prior to the Russian invasion of Ukraine, the EU was the primary trading partner for both Russia and Ukraine. In 2019, before the trade disruptions caused by the pandemic and the war, the EU accounted for 42 % and 40 % of Russian and Ukrainian exports, respectively. Since 2011, but especially after the Russian annexation of Crimea, there has been a massive shift of Ukrainian imports away from Russia and towards the EU and China (Figure 1). Russia, on the other hand, has increased its imports from China and decreased its dependency on the EU.

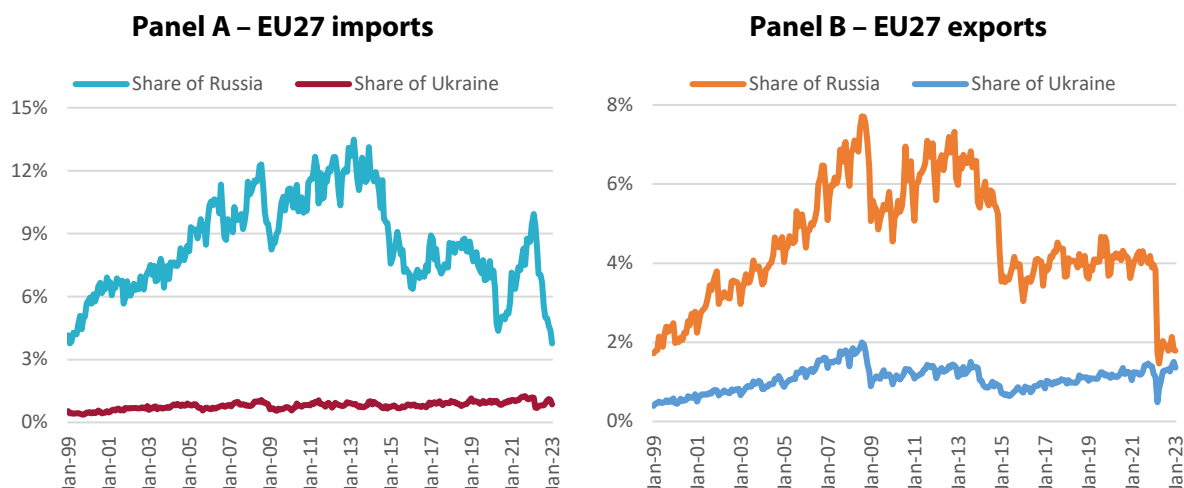
Figure 1: Share of selected trading partners in Ukrainian and Russian imports of goods, 1996-2022

Source: Bruegel based on IMF Direction of Trade Statistics dataset.

From the perspective of the EU, however, Russia and Ukraine account for only a small portion of total exports and imports (Figure 2). Russia gained some ground in total share of EU imports and exports since 1999, peaking at 13.5 % in March 2013 for imports and at 7.7 % in August and September 2008 for exports. Since then, we observe a downward trend ending at less than 4 % by December 2022. The exception is a significant increase in Russia's share of EU imports starting in 2020 due to the upsurge in fossil fuels prices driven by the reopening of the economy after the initial Covid-19 shock and later accentuated by the energy crisis with the war in Ukraine. In the case of Ukraine, its share in EU trade has not surpassed the 2 %.

As of January 2023, the EU exported a total of EUR 2.7 billion to Ukraine and EUR 3.6 billion to Russia, and imported around EUR 2 billion from Ukraine and EUR 8.8 billion from Russia. The still relatively high value of EU imports from Russia is mainly driven by mineral fuels, which is set to decline as the refined petroleum import ban of the EU becomes effective on 5 February 2023 (Darvas and Martins, 2022). As for Ukraine, since September 2022, cereals are the main EU import product, followed by oil seeds. EU exports to these two countries have been dominated by chemical and manufactured products, and machinery and transport equipment¹.

¹ Standard International Trade Classification (SITC) 1-digit categories: 5 (Chemicals and related products), 6 (Manufactured goods), 7 (Machinery and transport equipment) and 8 (Miscellaneous manufactured articles).

Figure 2: Share of Russia and Ukraine in total EU trade

Source: Bruegel based on Eurostat. Notes: The denominator used was the total imports/exports for Extra EU27.

2.2 Foreign direct investment

Similarly to trade, the EU is the primary foreign investor in both, Russia and Ukraine. In 2017, the EU accounted for 65 % and 66 % of the stock of foreign direct investment (FDI) into Russia and Ukraine, respectively (Table 1). FDI statistics reflect direct investment relations between entities in two different countries, but often intermediate countries are used to hide the identity of investors. This is done to avoid taxes and to benefit from better protection than in countries with poor rule of law like Russia and Ukraine. Given the prominence of EU countries as central hubs for global tax avoidance, this significantly distorts officially recorded FDI statistics.

Finding the actual origin of an investor in FDI relations is not straightforward. Damgaard et al (2019) provide some estimates of FDI by ultimate investor economy (UIE). According to these data, only roughly half of EU FDI into Russia and Ukraine ultimately comes from EU countries (Table 1, row (7)). Interestingly, the discrepancy between these two figures is almost completely compensated by FDI deriving from Russia and Ukraine themselves (Table 1, rows (4) to (6)). This suggests that Russian and Ukrainian investors are using the EU as a vehicle to invest in their own countries. The share of Russia and Ukraine as UIE in their own countries (Table 1, rows (3)) is very high. They are second only to China, with only 7 countries having an average share of over 15 % for the period 2013 to 2017.

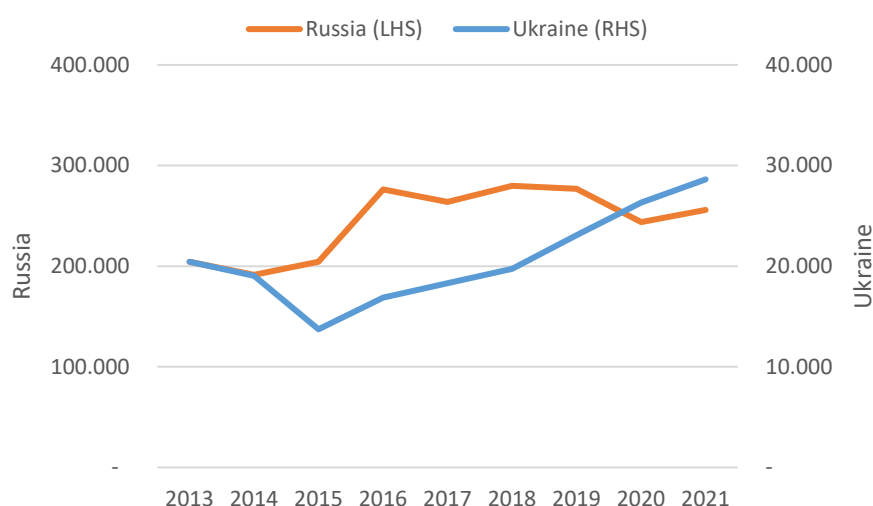
Table 1: Reported and ultimate investing economy (UIE) of FDI stock in Russia and Ukraine

Panel A: Russia	2013	2014	2015	2016	2017	2013-2017
(1) Reported FDI of EU/total FDI in Russia	68 %	71 %	68 %	64 %	65 %	67 %
(2) FDI EU as UIE/total FDI in Russia	37 %	39 %	38 %	33 %	35 %	36 %
(3) FDI Russia as UIE/total FDI in Russia	23 %	24 %	24 %	23 %	23 %	23 %
(4) = FDI EU as UIE – Reported FDI EU	147 064	-91 842	-80 005	123 319	130 761	572 990
(5) FDI Russia as UIE	110 651	69 277	61 986	91 565	102 282	435 762
(6) = -(4)-(5)	36 413	22 565	18 018	31 753	8 479	137 228
(7) FDI EU as UIE/Reported FDI EU	54 %	55 %	55 %	51 %	54 %	54 %

Panel B: Ukraine	2013	2014	2015	2016	2017	2013-2017
(1) Reported FDI of EU/total FDI in Ukraine	74 %	71 %	70 %	68 %	66 %	71 %
(2) FDI EU as UIE/total FDI in Ukraine	41 %	35 %	41 %	35 %	40 %	39 %
(3) FDI Ukraine as UIE/total FDI in Ukraine	27 %	28 %	25 %	29 %	26 %	27 %
(4) = FDI EU as UIE – Reported FDI EU	-19 406	-10 534	-5 357	-8 348	-6 672	-50 316
(5) FDI Ukraine as UIE	16 083	8 322	4 650	7 404	6 607	43 067
(6) = -(4)-(5)	3 323	2 211	706	943	64	7 249
(7) FDI EU as UIE/Reported FDI EU	55 %	49 %	58 %	52 %	61 %	55 %

Source: Bruegel based on Damgaard et al (2019). Notes: Rows (4), (5) and (6) show values in million USD.

While Damgaard et al (2019) only provide data up until 2017, Eurostat data shows that there has not been a large change in EU total investment going into Russia since 2017, but EU investment in Ukraine increased by around 55 % (Figure 3). The net FDI stock, i.e., assets EU residents hold abroad minus liabilities EU residents have towards other countries' residents, increased from EUR 18 billion in 2017 to EUR 29 billion in 2021 for Ukraine and marginally declined from EUR 264 billion in 2017 to EUR 256 billion in 2021 for Russia. In comparison with the total FDI of the EU27 abroad, these figures are rather small, accounting for less than 1 % in the case of Ukraine and less than 4 % in the case of Russia.

Figure 3: Net EU FDI stock in Russia and Ukraine (million EUR)

Source: Bruegel based on Eurostat. Notes: Variable reported in net FDI outward which is calculated by subtracting liabilities of EU residents from the assets EU residents hold abroad.

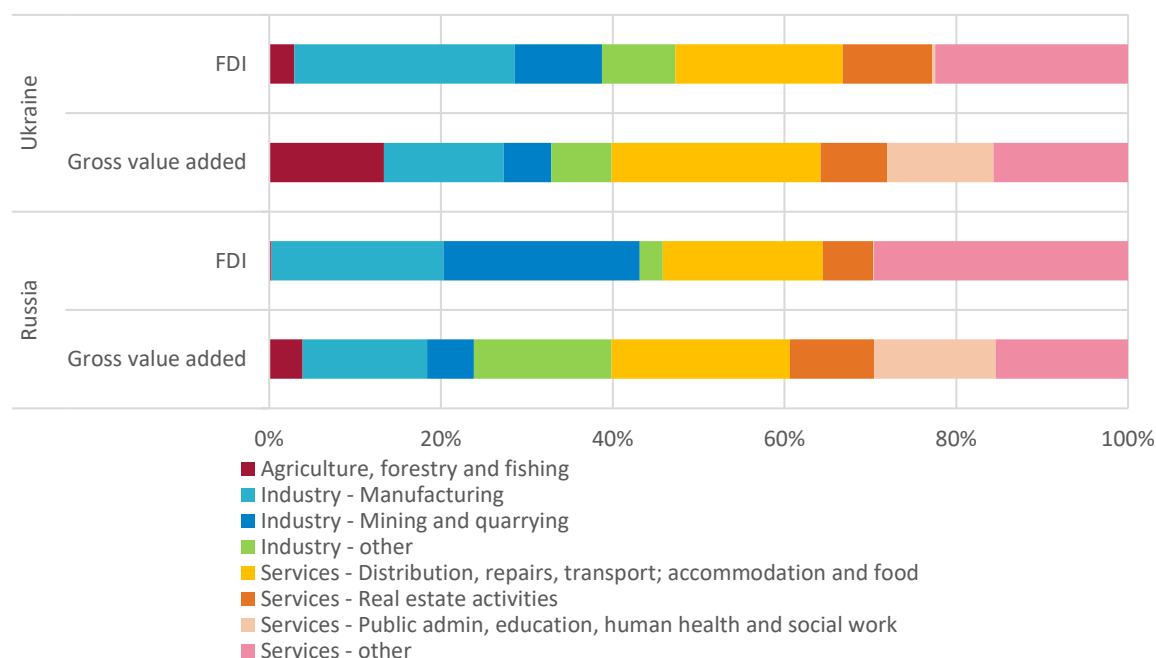
2.3 The structure of the Ukrainian and Russian economies

In 2019², people employed in companies in Russia and Ukraine controlled by EU27 countries accounted for roughly 1 % of the labour force in both countries. However, the turnover generated by these affiliates in both countries was considerable, slightly above 19 % of the respective gross domestic product (GDP) for Ukraine and around 10 % for Russia. These numbers are likely understated given that for multiple economic sectors, Eurostat does not report any numbers as that is confidential information.

For Ukraine, it was not possible to obtain a breakdown by economic sectors, but for Russia, the data available shows that most of these affiliates operate in the manufacturing sector and in wholesale and retail trade and repair of vehicles. These are precisely the two economic activities generating more gross value added in the Russian and Ukrainian economies (Figure 4). Therefore, the large-scale withdrawal of EU foreign affiliates from Russia since the outbreak of the war will have a significant impact on the Russian economy.

The distribution of FDI going towards Russia and Ukraine does not follow the same distribution of the value added (Figure 4). The decomposition of gross value added (GVA) for Russia and Ukraine shows that services account for around 60 % of the GVA in both economies. However, the Ukrainian economy still derives a considerable part of its value added from agriculture, forestry, and fishery (13 %), while for Russia, this sector is relatively small (4 %), with industrial activities having more weight. Manufacturing, mining, and quarrying, and other services received disproportionately more FDI than what these sectors produce. The higher share of other services is driven by financial and insurance activities.

Figure 4: Gross value added and the stock of FDI in Russia and Ukraine by economic activity (2019)



Sources: Bruegel based on State Statistics Service of Ukraine (Ukraine gross value added), National Bank of Ukraine (Ukraine FDI), Bank of Russia (Russia FDI) and OECD (Russia gross value added).

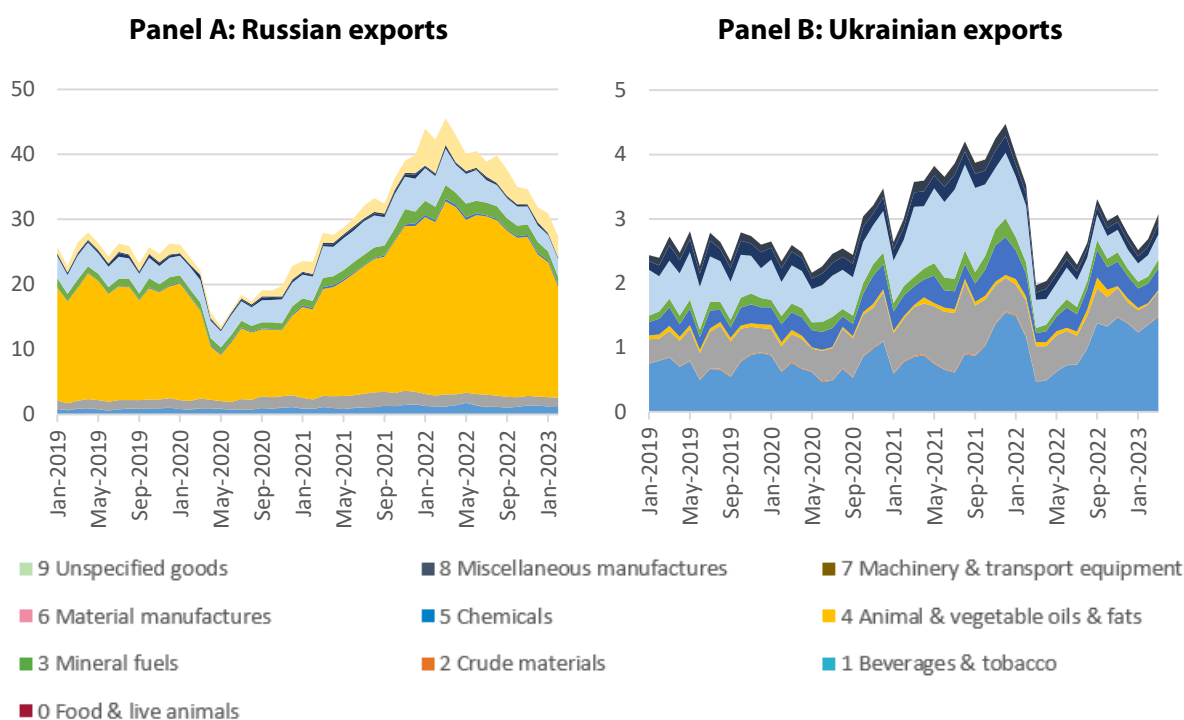
Russian exports are dominated by mineral fuels, with material manufactures coming second with a large gap (Figure 5, Panel A). These types of commodities would relate more closely with mining and quarrying in the value-added decomposition, but they also involve a wide range of services connected with the

² We consider 2019 figures since it was the last year of relatively normal activity before the Covid-19 pandemic and the full-scale Russian invasion of Ukraine.

activity. Hence, disruptions in the exports of mineral fuels can potentially have dramatic effects on the Russian economy.

Ukrainian exports have traditionally been more diversified, with both various food commodities and material manufactures playing a more prominent role than in Russia (Figure 5, Panel B). Since the war, however, Ukrainian exports have become somewhat less diversified, with food commodities³, in particular cereals, having more weight in total exports (around 48 % in March 2023). The exports of food commodities recovered to pre-war levels. Impediments to the normal functioning of some industries, especially in areas close to the frontline of conflicts, have taken a toll on manufacturing production, also affecting Ukrainian exports.

Figure 5: Russia and Ukrainian exports of goods by SITC 1-digit product categories to 37 and 39 countries, respectively (USD billion)



Source: Bruegel based on Ukrainian Official statistics and for Russian mirror statistics: Eurostat, General Administration of Customs –People's Republic of China, United States Census Bureau, Korea Customs Service, Ministry of Finance – Trade Statistics of Japan, Ministry of Commerce and Industry – Government of India, Office of National Statistics (UK), Turkish Statistical Institute, Swiss Federal Office for Customs and Border Security, Statistics Norway, Comex Stat (Brazil). Notes: Data starts in January 2019 and goes until February 2023 in Panel A and until March 2023 in Panel B.

3 Value chain dependencies between EU, Ukraine and Russia

As described above, the trade relationships between the EU and both Ukraine and Russia were asymmetric. Both countries accounted for a small share of EU exports and received a diverse set of goods from the EU. At the same time, the EU was the main export market for both countries and they mainly exported commodities to the EU. EU companies and investors in Russia were key players in the Russian manufacturing sectors, and the divestment since the war erupted upended several key manufacturing

³ Here it was considered SITC 1-digit category '0 Food & live animals'.

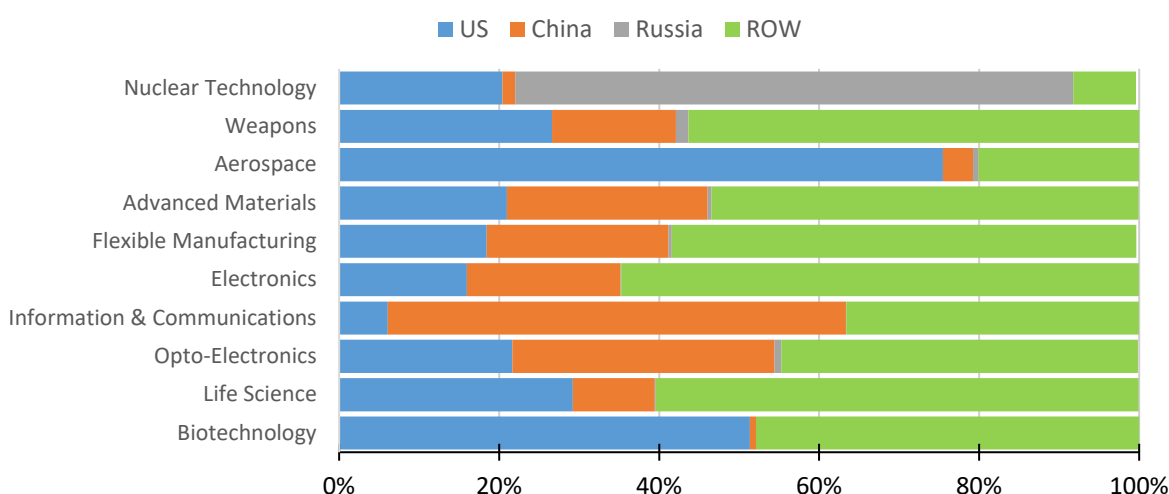
sectors (Demertzis et al., 2022). On the other hand, the integration of Russia, in particular in European value chains, was rather limited.

After the fall of the iron curtain, the more advanced industries that were operating in the Soviet Union suddenly had to compete with Western companies. On top of that, Russia suffered from a resource curse, where the appreciation of fossil fuel prices led to an appreciation of the real exchange rate, making non-resource exports relatively less competitive. This accelerated the demise of many of Russia's industries. Russia only joined the WTO in 2012, and it continued to have relatively high costs of exporting, which on top of the lack of an independent legal system, made it a difficult place for multilateral companies to set up factories as integral parts of their value chains (Domínguez-Jiménez and Poitiers, 2019).

3.1 Nuclear technology dependency

Nevertheless, there are a few dependencies on Russia, in particular nuclear technology supply. Figure 6 shows the EU imports of Russian high-tech goods. It illustrates the importance of Russian nuclear imports into the EU, while the EU imports barely any other high-tech goods from Russia.

Figure 6: EU imports of high-tech goods in 2019



Source: Grzegorzczuk et al. (2022).

Five EU countries are operating a total of 18 Russian-designed nuclear reactors, and Russia is a key source of parts and fuel for these reactors as well as of uranium (see Grzegorzczuk et al., 2022). While nuclear fuel does not constantly have to be replaced and import data is thus lumpy, the fuel rods and parts have to be specially produced and certified for a particular type of reactor. This means that replacing Russian-sourced nuclear fuel with alternatives is challenging (see Dolzikova, 2023).

Ukraine had a somewhat more diversified set of exports to the EU. A key example of Ukrainian integration in European value chains was plants that produce wire harnesses for the automotive industry. They are a labour-intensive intermediate input, for which Ukraine was responsible for roughly a fifth of the supply to the EU. A combination of war-related factory shutdowns and difficulties in moving parts and final products led to disruptions in the supply of these wire harnesses, which in turn negatively affected European automotive production⁴. Since then, production has largely resumed⁵.

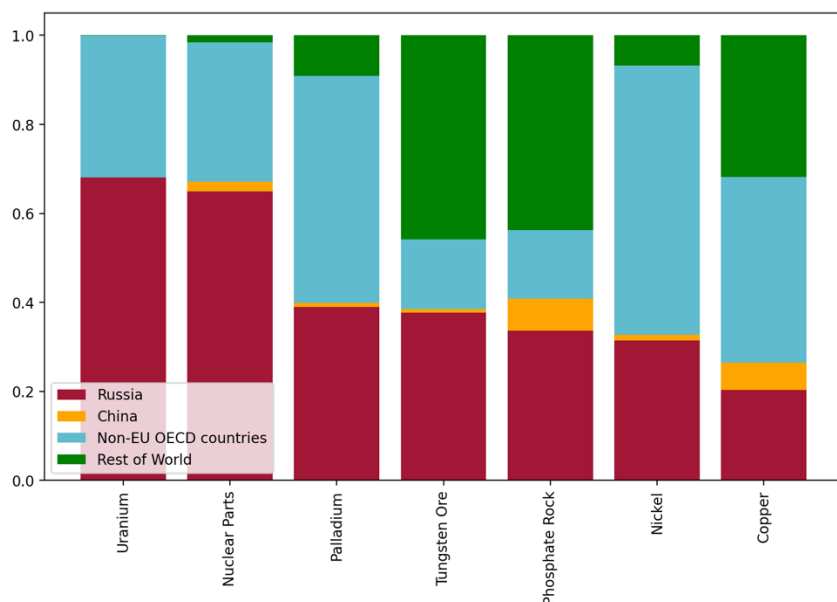
⁴ P. Campbell and J. Miller 'Europe's car plants halted by lack of low-cost Ukrainian component', Financial Times on 16 March 2022, available at <https://www.ft.com/content/1d0522d0-5bb2-4c49-8978-6fb99fec7e24>

⁵ See for instance P. Sigal 'Leoni says Ukraine output of wire harnesses nearly at pre-war levels', Automotive News Europe on 11 May 2022, available at <https://europe.autonews.com/suppliers/leoni-says-ukraine-output-wire-harnesses-nearly-prewar-levels>

3.2 Commodities in European value chains

Given that most exports from Ukraine and Russia to the EU are basic commodities, the primary exposure of EU value chains to the war was through commodity markets. Apart from fossil fuels, Russia is a major source of several critical raw materials (CRMs) for the EU. Figure 7 shows the import sources for CRMs in which Russia is a main provider. Especially in the nuclear industry, Russia is a main provider of such goods (Rietveld et al. 2022). But Russia also provides significant shares of EU imports of palladium, tungsten, phosphate, nickel and copper.

Figure 7: Origins of EU imports of Critical Raw Materials with high Russian market share



Source: Rietveld et al. (2022).

Other key commodities affected by the war were 'rare gases'. The gases neon, krypton and xenon are produced as a by-product of steel production. An integrated supply chain between Russian steel producers that supplied the gas, which was then purified in Ukraine, accounted for a large share of the global supply. Neon gas, for instance, is used particularly in the semiconductor supply chain and there were worries that this could lead to a further shortage. This was already an issue during the Russian annexation of Crimea, when prices surged by 600 % (Grzegorzczuk et al., 2022). Since 2014, firms that rely on neon gas have increased inventories and aimed for diversification. The usage of these reserves as well as substitution with alternative gases, new supply and simply trade diversion, meant that there were no major disruptions despite a temporary surge in prices⁶.

Given that most exports from these two countries are commodities, the war-related disruptions of production and exports were reflected in higher prices for European industries and not in the breakdown of their supply chains. In sectors like agriculture and raw materials for industrial use, the difficulty in producing in Ukraine and the additional hurdles to export from Russia meant that fewer goods were available on European and global markets and thus, prices for these goods rose considerably. Key examples of this are the energy-intensive industries, where there were large decreases in production in Europe occurred (Zachmann et al., 2022).

⁶ 'How rare-gas supply adapted to Russia's war', The Economist, 30 March 2023, <https://www.economist.com/finance-and-economics/2023/03/30/how-rare-gas-supply-adapted-to-russias-war>.

4 EU bilateral treaties with Russia and Ukraine

4.1 EU-Russia trade and investment agreements

EU-Russia trade relations are primarily governed by WTO rules, as the EU does not have a free trade agreement with Russia. Russia's accession to the WTO was only in 2012, and unlike the EU, Russia has not built an extensive global network of free trade agreements (FTAs). It has free trade agreements with 13 countries, most of which are from the Commonwealth Independent States (CIS) and located in Russia's proximity. This limits the usefulness of these trade agreements as they share similar trade profiles, and these countries only accounted for roughly 14 % of Russian exports in 2019 (before the war and the pandemic). Russia has mostly tried to advance its economic relationship through the Eurasian Economic Area, which consists of Russia, Armenia, Belarus, Kazakhstan, and Kyrgyzstan and also includes a customs union. The EU and Russia had a Partnership and Cooperation Agreement (PCA) since 1997, but this did not include preferential trade access. Negotiations over an update of this agreement were suspended in 2014 after the Russian annexation of Crimea⁷. Until the outbreak of the war, the bilateral trade relations between the EU and Russia were thus governed through WTO Most Favoured Nation (MFN) treatment.

While the EU did not sign nor negotiate an FTA with Russia, there is an extensive network of bilateral investment treaties between EU countries and Russia. There are 23 BITs between EU countries and Russia, most of which were signed in the 1990s. They include investor-state dispute settlement (ISDS), which provides foreign investors protection against various forms of expropriations. A prominent case of their application followed the forced breakup and sale of Yukos, a former Russian oil and gas company. Investors seek compensation for this under the Energy Charter Treaty, an international agreement primarily covering trade and investments in fossil fuels that includes ISDS provisions. As part of these proceedings, an arbitration panel awarded a record sum of USD 50 billion in compensation, but the awards are still undergoing review by national courts in the Netherlands⁸. Given the large number of expropriations that have taken place in Russia since the outbreak of the war, it can be expected that investors will seek compensation for them under ISDS in Russian BITs⁹.

At the outset of the war, the EU and a group of like-minded countries suspended the MFN treatment from which Russia benefited as a member of the WTO¹⁰. For Canada¹¹ and Australia¹², this implied the imposition of a 35 % tariff on Russian goods, because these countries apply such tariffs on goods from non-MFN countries. The UK imposed an extra tariff of 35 % on key Russian exports and tariffs for Russian exports into the US also went up considerably, with, for instance, oil tariffs doubling (Cimino-Isaacs et al., 2022). The EU did not impose non-MFN tariffs on Russia. Instead, the EU targeted individual goods via sanctions, which however was also introduced by other countries.

⁷ COUNCIL DECISION 2014/145/CFSP of 17 March 2014, available at <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2014:078:0016:0021:EN:PDF>

⁸ This concerns three cases: Hulley Enterprises Ltd. v. Russian Federation (PCA Case No. 2005-03/AA226), Yukos Universal Limited v. The Russian Federation (PCA Case No. 2005-04/AA227) and Veteran Petroleum Limited v. The Russian Federation (PCA Case No. 2005-05/AA228).

⁹ <https://www.allenoverly.com/en-gb/global/news-and-insights/publications/international-law-considerations-for-foreign-investors-with-business-interests-in-russia>

¹⁰ For the letter of intent by the group of countries see, 'JOINT STATEMENT ON AGGRESSION BY THE RUSSIAN FEDERATION AGAINST UKRAINE WITH THE SUPPORT OF BELARUS' by Albania; Australia; Canada; European Union; Iceland; Japan; Republic of Korea; Republic of Moldova; Montenegro; New Zealand; North Macedonia; Norway; United Kingdom and United States, 15 March 2022, WTO Doc WT/GC/244 (22-2279), available at

https://www.eeas.europa.eu/sites/default/files/joint_statement_on_aggression_by_the_russian_federation_against_ukraine.pdf

¹¹ Cimino-Isaacs et al. (2022).

¹² <https://www.foreignminister.gov.au/minister/marise-payne/media-release/australia-impose-tariff-increases-all-imports-russia>

4.2 The DCFTA with Ukraine

Trade relations between Ukraine and the EU began in 1994 following the signing of the Partnership and Co-Operation Agreement (PCA).¹³ It comprised an Interim Agreement which came into force in 1996 and covered trade issues, including MFN treatment, non-discrimination of foreign companies, liberalisation of capital transfers and competition rules.¹⁴ Like Russia, Ukraine only entered the WTO late in 2008, but has benefited from preferential trade access to the EU since the EU-Ukraine Association Agreement (AA) in 2014.¹⁵ The AA aimed for political association and economic integration between the EU and Ukraine and contained provisions on political elements such as human rights, rule of law and economic and financial cooperation.¹⁶ The decision by then President Yanukovich not to sign the AA led to a political crisis in 2013 and to the Euromaidan movement. In the midst of the ensuing political turmoil Russia annexed Crimea. Trade-related matters part of the AA are covered under the Deep and Comprehensive Free Trade Area (DCFTA).¹⁷ The DCFTA was provisionally applied since 2016, and both the AA and DCFTA were officially ratified and came into force on 1 September 2017.¹⁸

The DCFTA provides “a framework for modernising its trade relations and for economic development” with the goal of opening market and harmonising EU and Ukrainian economic standards.¹⁹ It eliminates the majority of tariffs, transitional periods notwithstanding. Trade of many agricultural goods was liberalised on both sides, however, a number of them continue to be subject to measures such as tariff rate quotas. As a comprehensive FTA, the DCFTA also covers virtually all aspects of EU-Ukraine trade relations.²⁰

Since the outbreak of the war, the EU has suspended all import tariffs on Ukrainian goods by the EU and anti-dumping tariffs that were imposed on Ukrainian metal products as part of a trade conflict were abolished.²¹ The EU also established so-called ‘solidarity lanes’ to expedite Ukrainian food export.²² While initially, the main concern was to get Ukrainian grain on global markets, low food prices led to Poland, Bulgaria, Hungary and Slovakia restricting imports of Ukrainian produce following protests by farmers unable to sell their crops.²³ These unilateral embargos were lifted after a deal was reached on 28 April 2023 with these four countries and Romania. The deal restored the solidarity lanes for wheat, maize, rapeseed and sunflower seed originating in Ukraine by ensuring their transit across these frontline states, but ended

¹³ European Commission Press Release, ‘PCA with Ukraine enters into force’, 27 February 1998, https://ec.europa.eu/commission/presscorner/detail/en/IP_98_198

¹⁴ European Commission Press Release, ‘PCA with Ukraine enters into force’, 27 February 1998, https://ec.europa.eu/commission/presscorner/detail/en/IP_98_198

¹⁵ Ministry of Foreign Affairs of Ukraine, ‘Ukraine and WTO’, 18 December 2019, <https://mfa.gov.ua/en/about-ukraine/cooperation-international-organizations/ukraine-and-wto>

¹⁶ European External Access Service, ‘EU-Ukraine Association Agreement’, https://www.eeas.europa.eu/sites/default/files/071215_eu-ukraine_association_agreement.pdf

¹⁷ European External Access Service, ‘EU-Ukraine Association Agreement’, https://www.eeas.europa.eu/sites/default/files/071215_eu-ukraine_association_agreement.pdf

¹⁸ DG Trade, ‘EU-Ukraine Deep and Comprehensive Free Trade Area’, <https://trade.ec.europa.eu/access-to-markets/en/content/eu-ukraine-deep-and-comprehensive-free-trade-area>

¹⁹ European External Access Service, ‘EU-Ukraine Association Agreement’, https://www.eeas.europa.eu/sites/default/files/071215_eu-ukraine_association_agreement.pdf

²⁰ DG Trade, ‘EU-Ukraine Deep and Comprehensive Free Trade Area’, <https://trade.ec.europa.eu/access-to-markets/en/content/eu-ukraine-deep-and-comprehensive-free-trade-area>

²¹ Regulation 2022/870, PE/21/2022/REV/1, OJ L 152, 3.6.2022, p. 103–108, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32022R0870>

²² DG Mobility and Transport, ‘Solidarity Lanes: European Commission launches EU-Ukraine business matchmaking platform’, https://transport.ec.europa.eu/news/solidarity-lanes-european-commission-launches-eu-ukraine-business-matchmaking-platform-2022-06-03_en

²³ Politico, ‘Eastern EU countries strike deal with Commission to clear Ukrainian grain glut’, 28 April 2023, <https://www.politico.eu/article/eastern-europe-poland-deal-with-eu-clear-ukrainian-grain-glut/>

the free circulation of the above crops inside these five countries.²⁴ The Commission also allocated EUR 100 million to compensate farmers in these five member states, which will be taken from the agricultural reserve for 2023.²⁵

5 The process of Ukraine's approximation and accession to the EU

Ukraine became an EU candidate country on the 23rd June 2022²⁶ following the Commission's recommendation 6 days earlier.²⁷ This was an important political milestone, yet just the beginning of a long technical process (Dabrowski, 2022). Indeed, moving to the next stage of the process, where negotiations are opened officially, is dependent on Ukraine fulfilling the seven *opening benchmarks* set out in the Commission's initial recommendation for Ukraine to become a candidate country. These seven *opening benchmarks* cover a range of issues from constitutional court reform and judiciary reform to anti-oligarch reform and legislation on national minorities.^{28,29}

Whilst there has been some progress in these areas over the years, there is much left to do, particularly concerning constitutional court reform and anti-oligarch reform.³⁰ It can take several years to open membership negotiations – North Macedonia has been waiting 17 years since it was granted candidate status, and is yet to start negotiations (Dabrowski, 2022).

Even after negotiations open, the process is long and technical. Each of the 35 chapters of *acquis* needs to be negotiated, each of them covering a vast array of issues (Chapter 11 is called Agriculture and rural development, for example) (Dabrowski, 2022). Since 2003, when six Western Balkan countries received a commitment from the EU to support their integration, only Croatia has joined the EU (Sapir, 2022).

5.1 State of play of accession process

The AA (and DCFTA) acts as a good baseline for the future accession process. Its fundamental objective, outlined in the opening Article 1(d) of the EU-Ukraine AA, is to align Ukraine legislatively and economically.³¹ The Commission's opinion for Ukraine to be granted candidate status praised Ukraine in having approximated substantially across many chapters of the AA.³² Indeed, the DCFTA has succeeded in implementing trade-related reforms in public procurement, competition and countering technical barriers to trade over 2014 – 2019, but reforms slowed post 2019 elections. Challenges in transport, the financial sector and customs reforms remain (Rabinovych, 2022).

²⁴ European Commission Press Release, 'Commission adopts exceptional and temporary preventive measures on limited imports from Ukraine', 2 May 2023

²⁵ European Commission, 'EUR 100 million to support farmers from Bulgaria, Hungary, Poland, Romania and Slovakia', 3 May 2023, https://agriculture.ec.europa.eu/news/eu100-million-support-farmers-bulgaria-hungary-poland-romania-and-slovakia-2023-05-03_en

²⁶ European Council Enlargement Policy, 'Ukraine', <https://www.consilium.europa.eu/en/policies/enlargement/ukraine/>

²⁷ European Commission, 'Commission Opinion on Ukraine's application for membership of the European Union', 17 June 2022, <https://neighbourhood-enlargement.ec.europa.eu/system/files/2022-06/Ukraine%20Opinion%20and%20Annex.pdf>

²⁸ European Commission DG NEAR, 'Steps towards joining', https://neighbourhood-enlargement.ec.europa.eu/enlargement-policy/steps-towards-joining_en

²⁹ See full breakdown and evaluation of the opening benchmarks <http://neweurope.org.ua/en/visual-materials/kandydat-check-3-de-ukrayina-perebuyaye-u-vykonanni-semy-rekomendatsij-yes-shhodo-kandydatstva/>

³⁰ New Europe Center, 'Candidate Check-3: Where Ukraine is in the implementation of 7 EU recommendations regarding candidacy', 1 February 2023, <http://neweurope.org.ua/en/visual-materials/kandydat-check-3-de-ukrayina-perebuyaye-u-vykonanni-semy-rekomendatsij-yes-shhodo-kandydatstva/>

³¹ Association Agreement, available at [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:22014A0529\(01\)&from=EN](https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:22014A0529(01)&from=EN)

³² European Commission, 'Commission Opinion on Ukraine's application for membership of the European Union', 17 June 2022, <https://neighbourhood-enlargement.ec.europa.eu/system/files/2022-06/Ukraine%20Opinion%20and%20Annex.pdf>

But issues outside of the DCFTA had limited progress. The fundamental issues of corruption, weak rule of law, strong oligarchic influence have prevented the DCFTA acting as a quick catalyst for both liberalisation of Ukraine's markets and for Ukraine's integration into sections of the EU internal market (Rabinovych, 2022; Van der Loo and Van Elsuwege, 2022). Indeed, 7 out of the 26 chapters of the AA have been identified as areas where Ukraine needs to make big improvements, only one of which concerned the DCFTA (Emerson and Movchan, 2021).

Table 2: Ratings of implementation by Ukraine of main provisions of the Association Agreements and DCFTAs

Political principles, rule of law	Rating	
<i>Anti-corruption</i>	1	Marginal improvement, inconsistent stance of leadership
<i>Rule of law</i>	1.5	Judicial reform badly needed, not advancing consistently
DCFTA		
<i>Intellectual property rights</i>	1.5	Limited progress in IPR protection and enforcement
Economic cooperation		
<i>Macroeconomic policy</i>	1.5	Improved but still vulnerable; IMF/EU aid-dependent
<i>Transport</i>	1	Road transport needs action by Ukraine (and EU)
<i>Consumer protection</i>	1.5	Progress in product safety, but much more outstanding
<i>Company law</i>	1.5	Legislative action, but uncertain enforcement

Source: Bruegel adapted from Table A1 from Emerson and Movchan, 2021. 3=good implementation, 2=moderate degrees of implementation, or a reasonable state of work in progress where there are still time lags for implementation, 1=only 'some' progress in implementation, 0=no progress. These are based on the Commission's methodology for assessing the Balkan states for the same chapters.

Anti-corruption and judicial reforms have also appeared in the European Commission's opening benchmarks in the recommendation to Ukraine's accession to candidacy status, underlining the focus on and need for reform in these areas. Other previously recognised key issues are slow progress and a lack of comprehensiveness of the reform process up until 2020, reliance on international financial support and lack of progress on privatisation (Dabrowski, Domínguez-Jiménez and Zachmann, 2020).

Whilst it may have been slow, there has been some progress in reforms in more recent years. The 2022 Association Implementation Report, which covered Ukraine's implementation of its commitments under the AA up until Russia's full invasion, showed progress on some of these issues.³³ Ukraine passed a de-oligarchisation law in November 2021, implemented reforms on the High Council of Justice, and in Spring of 2021 lifted the ban of privatisation of large assets. However, it still lacked reform on the Constitutional Court for the competitive selection of judges.

5.2 Outlook

In September 2021, the EU and Ukraine agreed on a Priority Action Plan for deepening the trading relationship, which was extended and revised again in October 2022 to focus on the enhanced implementation of the DCFTA over 2023-2024.³⁴ This plan aims use the DCFTA to its "full potential" under the renewed impetus from Ukraine's accession to candidate status. This action plan contains amendments on four groups, which cover trade facilitation and market access.

³³ European Commission, 'Association Implementation Report on Ukraine', 22 July 2022, <https://www.eas.europa.eu/sites/default/files/documents/Association%20Implementation%20Report%20on%20Ukraine%20-%20Joint%20staff%20working%20document.pdf>

³⁴ See Priority Action Plan: For enhanced implementation of the EU-Ukraine DCFTA in 2023-2024 at <https://circabc.europa.eu/rest/download/f3a2634c-f484-4874-a72d-be088c94d1e8>

There is some debate on the adequacy of the legal framework of the DCFTA and AA as vehicles for Ukraine's accession to the EU (Van der Loo and Van Elsuwege, 2022; Rabinovych, 2022). Beyond the technical aspects of Ukraine's accession, a more fundamental question remains. As Sapir (2022) notes, whilst poor quality of governance and corruption will likely be dealt with by the massive reconstruction which will transform Ukraine's governance, only a full victory will result in full territorial integrity once again. Some EU countries may be hesitant to accept a country partly-occupied by Russia, especially if it prevents reconstruction leading to improved governance (Sapir, 2022).

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BRIEFING

The current situation (1st quarter 2023) of and prospects for trade and investment relations with Ukraine and Russia

ABSTRACT

The paper provides a data-supported analysis of recent trade developments. It starts with an analysis of EU alternatives for Russian imports, focusing on the energy sector and critical raw materials. It then analyses how/to which countries Russia's and Ukraine's trade was redirected since February 2022, addressing changes to trade routes (maritime, inland transport). The last section focuses on Ukraine's current trade challenges, describes the various initiatives already introduced to support Ukraine's trade, and discusses possible further EU support measures, also informed by interviews with experts from the region.

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Executive summary

Alternatives to Russian energy

- The share of Russian natural gas present in EU supply fell from 40 % before the full-scale invasion of Ukraine to around 8 % from Russian pipeline imports and a further 5-10 % from Russian liquefied natural gas (LNG) imports. Demand reduction (660 TWh) and increased LNG imports from various countries (390 TWh) compensated for the fall of Russian pipeline imports (950 TWh) in April 2022 to March 2023, compared to the preceding 12-month period.
- The deployment of extra LNG import infrastructure will reduce dependence on Russia further, while some demand reductions should become structural, fostered by increased deployment of renewables, heat pumps and energy efficiency measures.
- The EU embargo on the seaborne import of Russian crude oil has been successfully implemented without adverse effects on the EU.
- While accounting for a large share of imports, the EU's dependence on Russian diesel was just about 10 % of the EU's supply and the embargo was managed smoothly. The EU is not at risk of supply shortages. However, various global factors have led to tight global diesel markets and therefore prices for road diesel remain high in the EU. Reducing demand for diesel remains the key strategy.
- Phasing out Russian heavy fuel oil and naphtha did not cause disruptions to EU markets.

Critical raw materials

- Before the outbreak of war, Russia was a key provider of several critical raw materials to the EU. Since the war began, Russia's share of EU imports has declined for most critical raw materials, and the EU was able to divert its imports from other countries.
- There was a mostly temporary surge in the prices of critical raw materials after the full-scale invasion, but prices later returned to lower levels as Ukrainian supply stabilised and alternative sources were found.

Russian trade developments

- We reconstructed data on Russia's foreign trade based on bilateral statistics published by the statistical offices or trade ministries of 37 countries, which accounted for 77 % of Russian trade in 2019.
- The nominal value of Russian mineral fuel exports, which was quite low during the COVID-19 pandemic, rose due to both quantity and price effects by March 2022. Since April 2022, Russian mineral fuel revenues have been falling largely due to the fall in EU imports. These decreased from USD 17.4 billion in March 2022 to USD 2.2 billion in March 2023. China overtook the EU as the most important market for Russia's fossil fuels, while India and Turkey have also increased mineral fuel imports from Russia. The US and the UK have phased out Russian-sourced fossil fuels.
- There was also a considerable fall in Russian exports of goods other than mineral fuels, which might suggest that the war and the various sanctions imposed have already started to damage the productive capacity of the Russian economy.
- There was a dramatic drop in Russian imports when the full-scale war began and there has been an uneven recovery since. Imports from the EU remained less than half compared to the average in 2021, while imports from China surpassed pre-war values in March 2023. Russian imports from Turkey, starting from a low level, more than doubled the pre-war values by autumn 2022.

- The decline of Russian imports of product categories that include sanctioned products was much larger than the overall Russian import decline. Suppliers from China, India and Turkey were not able to fill the gap from the loss of Western producers.
- However, there are signs of circumvention of EU export bans via Armenia, Kazakhstan and Kyrgyzstan, which require EU action.

Ukrainian trade developments

- The EU, as Ukraine's main trading partner, became even more dominant due to trade liberalisation measures, improvement of logistics infrastructure (Solidarity Lanes), and geographical closeness. Blocked seaports and a greater distance hindered trade with Asia and Africa. Ukraine introduced a full embargo on trade with Russia after the full-scale invasion.
- Ukrainian exports of agricultural products and crude materials recovered close to pre-war values. Ukrainian exports of material manufactures declined sharply, partly because a lot of metals industry production capacity was in territories affected by the war.
- The grain corridor, which was negotiated with Russia, was instrumental in expediting some agricultural goods via sea. The corridor has limited coverage and resulted in more expensive and cumbersome transportation. It is also subject to uncertainties.
- The large inflow of agricultural products to neighbouring EU countries generated major tensions.
- Beyond physical damages to production facilities and infrastructure, the labour force decline and high security risks, Ukrainian producers are also financially constrained.

Possible further EU support measures

- Helping to expand transportation by the grain corridor to other goods and other seaports;
- Improving EU customs processes;
- Addressing transport infrastructure challenges;
- Strengthening public-private partnerships to boost and stimulate private capital inflows to Ukraine;
- Enhancing EU schemes supporting trade financing to Ukrainian companies;
- Extending the trade liberalisation measures by at least one more year.

1 The EU's alternatives to imports from Russia now and in the future

1.1 Alternatives to Russian energy

In exploring the evolution of the EU's energy imports vis-à-vis Russia, we make a distinction between natural gas, crude oil, and oil products. The situation and potential solutions for each of these commodities are substantially different.

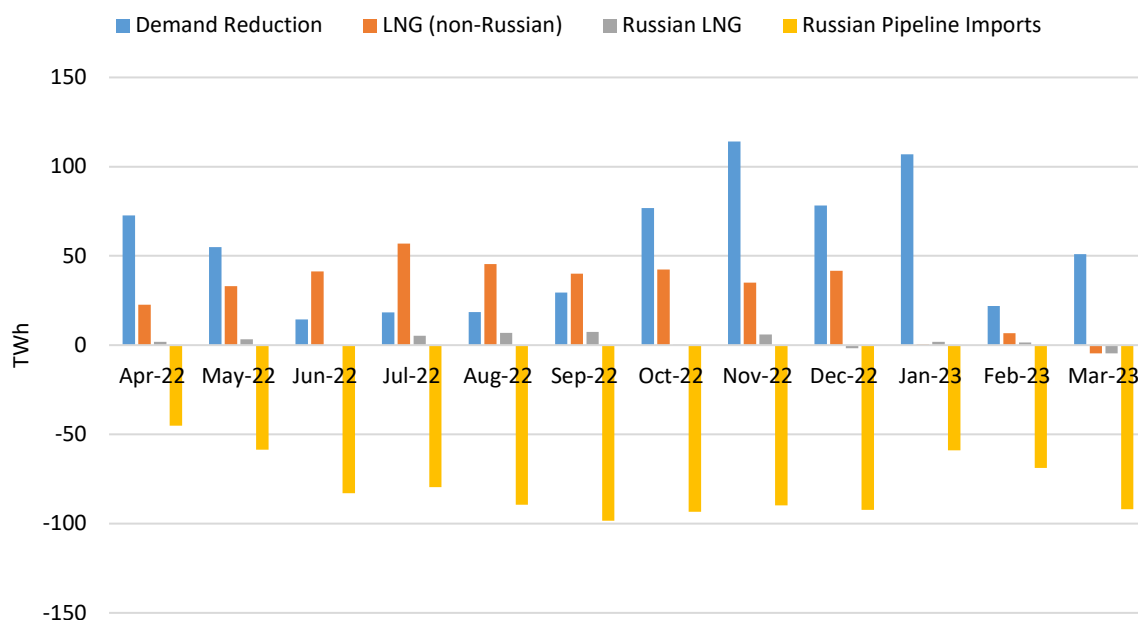
1.1.1 Natural gas

For the past few years, Russian natural gas provided 40 % of the EU's supply. Disruptions of Russian exports to the EU were apparent since summer 2021, when Gazprom notably failed to refill storage sites which the company managed in the EU. Throughout 2022, exports progressively fell, and by late August, flows were

halted through the Nord Stream pipeline bringing an end to the major share of Russian pipeline imports¹. Russian pipeline exports to the EU currently account for around 8% of the EU's supply, with flows continuing via Ukraine and the Turkstream pipeline. Russian liquefied natural gas (LNG) accounts for a further 5-10%.

The EU's response has been a two-pronged strategy of increasing LNG imports and reducing domestic demand for natural gas, both driven by market forces. In the gas year 1 April 2022 to 31 March 2023, Russian pipeline imports fell by 950 TWh year-on-year, while LNG imports increased 390 TWh, and demand was reduced by 660 TWh. Figure 1 shows the monthly evolution.

Figure 1: EU gas balance changes, April 2022–March 2023 (year-on-year, TWh)



Source: Bruegel based on the ENTSO-G transparency platform, Bruegel Natural Gas Demand Tracker².

Moving forward, the rapid deployment of extra LNG import infrastructure, particularly in north-west Europe, will tie the EU more closely to global gas markets. This will reduce dependence on Russia. At the same time, demand reductions should become structural. Measures such as the rapid deployment of renewables, heat pumps, and energy efficiency measures, will allow for continued demand reduction without harming economic activity (e.g., the forced closures of ammonia plants during winter 2022-23).

1.1.2 Crude oil and oil products

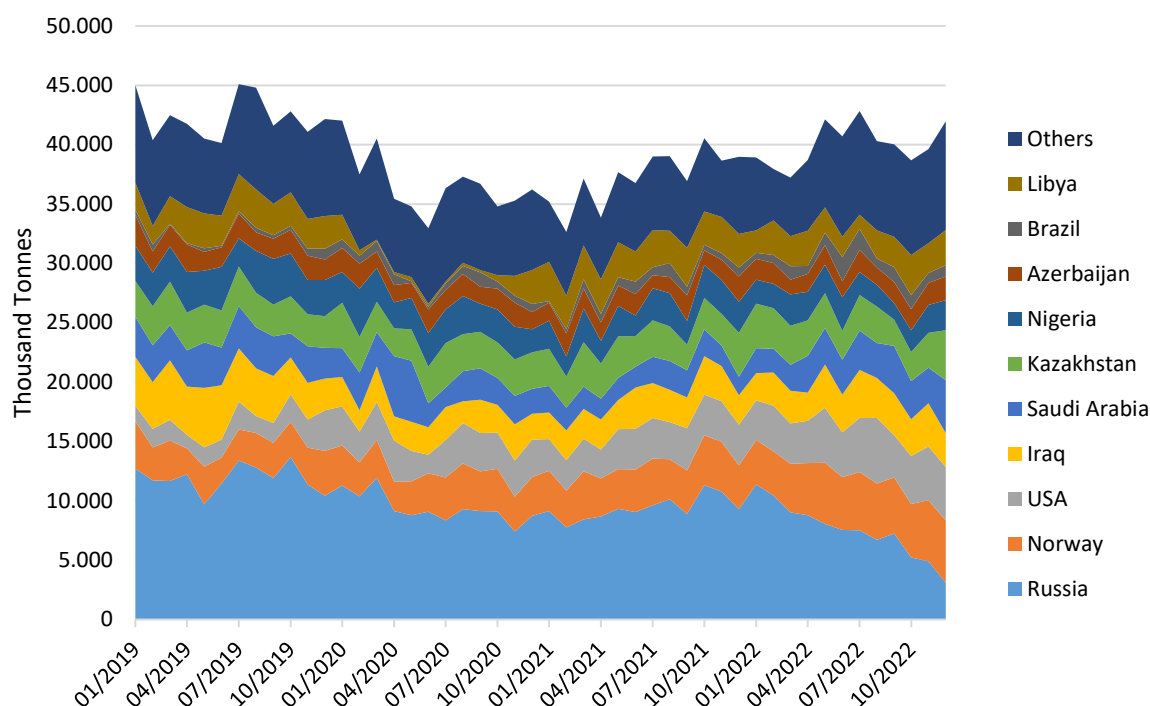
The EU implemented an embargo banning the seaborne import of Russian crude oil, which came into force on 5 December 2022 (with a temporary exemption granted to Bulgaria). The embargo has been successfully implemented without adverse effects on the EU. The global oil market is highly liquid, and the EU is able to import crude oil from a diverse pool of different suppliers beyond Russia. Historically, the largest share of imports to the EU, excluding Russia, has been from Norway, the USA, Iraq, Saudi Arabia, and Kazakhstan (Figure 2).

¹<https://www.bruegel.org/dataset/european-natural-gas-imports>

²<https://transparency.entsog.eu/#/map> and <https://www.bruegel.org/dataset/european-natural-gas-demand-tracker>

Pipeline imports of Russian crude oil are still permitted and continue through the Druzhba pipeline. However, as of January 2023, Germany has halted pipeline imports bringing the total value of imports through the Druzhba pipeline to half of their 2022 volumes³.

Figure 2: EU crude oil imports, January 2019–February 2023



Source: Bruegel based on Eurostat [database NRG_TI_OILM].

On 5 February a second embargo banned the import of refined oil products. The most relevant product is diesel both due to its economic relevance, and the EU's previously significant dependency on Russia for imports – with up to 50 % of imports typically coming from Russia. Despite this large import share, the EU has a substantial own refining capacity, with up to 80 % of supply met by domestic refinery output. Therefore, the Russian supply of 50 % imports accounted for around 10 % of total supply.

A variety of global factors have led to tight global diesel markets and therefore prices for road diesel remain high in the EU. High diesel prices have predominantly been caused by high margins for refining crude oil into diesel, not by high crude oil prices. For much of 2022, China limited the export of refined oil products, which tightened global markets (McWilliams, 2022). Disruptions to the trade of diesel from Russia to Europe, which was a key global diesel trading route, also contributed. From the second half of 2021, natural gas scarcity and exploding prices also pulled up the diesel price. A first reason is that they increased the energy costs of operations at oil refineries, particularly by raising the price of hydrogen (derived from natural gas) which is a key input to the process. Secondly, demand for diesel was increased as in some use cases it can be a substitute for natural gas. This was particularly notable in the energy use of European industry.

The EU is not at risk of supply shortages, but the situation should continue to be monitored for the impact of high prices on inflation and the cost of living. Reducing demand for diesel remains the key strategy for the EU to abate high prices.

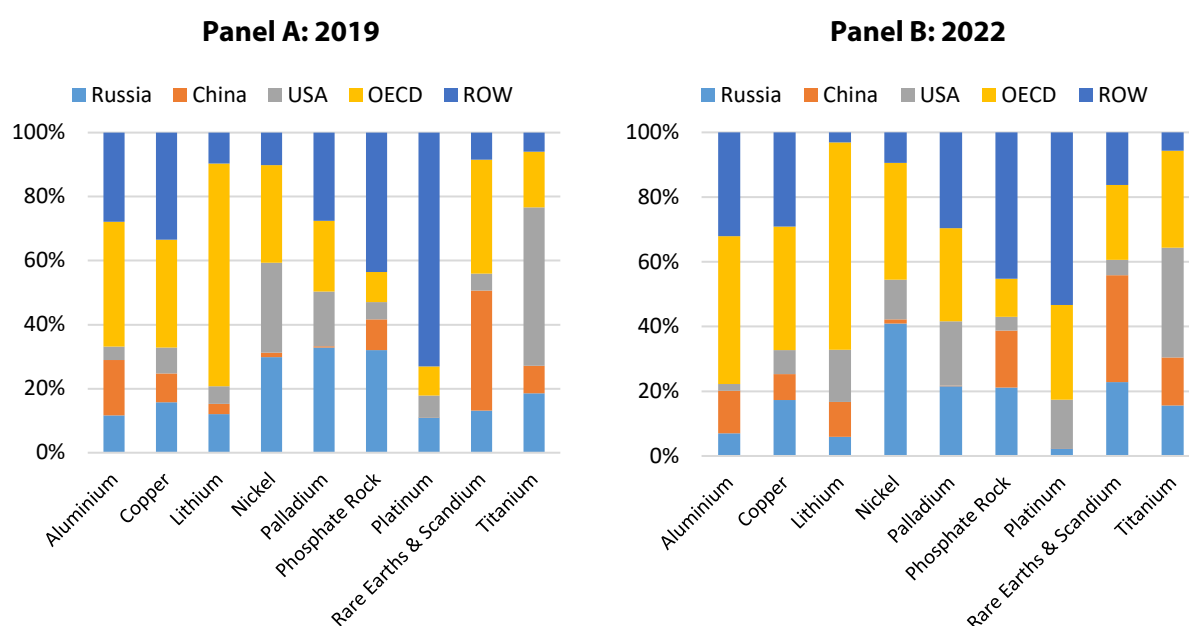
³ <https://www.bruegel.org/dataset/russian-crude-oil-tracker>

Meanwhile, heavy fuel oil (used for heating and as a shipping fuel) and naphtha (used in the chemicals industry) were the other two refined products for which the EU used to import significant Russian shares. In both cases, imports from Russia were phased out largely before the embargo began.

1.1.3 Critical raw materials

Before the full-scale war, Russia was a key provider of several critical raw materials (CRMs) to the EU. Out of the 34 CRMs identified as critical by the European Commission, Russia accounted for more than 10 % of 2019 EU imports in 9. These are displayed in Figure 3. For nickel, palladium and phosphate rock, Russia accounted for more than 30 % of EU imports in 2019. However, there is no CRM with a Russian import share beyond 65 %, the threshold for problematic market concentration used in the Critical Raw Materials Act (see Le Mouel and Poitiers, 2023). These direct import shares do not reflect global market shares, though. For instance, when it comes to nickel, one of the CRMs where Russia represents a large source of EU imports, there are a large variety of source countries (see Rietveld et al., 2022). Russia is also a major source of uranium and other nuclear fuel products, where there are also technological dependencies (Grzegorzczuk et al., 2022).

Figure 3: Share of EU imports of Critical Raw Materials from Russia, 2019 and 2022



Source: Bruegel based on Eurostat. Notes: The selected CRMs are those among the list of CRMs identified by European Commission (2023) with a Russian share of EU imports in 2019 of more than 10 %.

Since the outbreak of the full-scale war, Russia's share of EU imports has declined for most of them, though the Russian share of EU nickel imports remains high. There has been a surge in prices for some resources with Ukraine and Russian supply chains. This includes 'rare gases' that are produced in a supply chain including both Ukrainian and Russian production steps. An example of this is neon gas which is used in the production of semiconductors. But, after the initial price surge, prices have returned to lower levels as Ukrainian supply stabilised and alternative sources were found⁴. Nickel prices also more than doubled directly after the full-scale invasion from around USD 20 000 per ton to around USD 48 000 per ton. But, as in the case of rare gases, the price of Nickel levelled again, and in April of 2023, Nickel was traded again at around USD 24 000 per ton.

⁴ 'How rare-gas supply adapted to Russia's war', The Economist, 30 March 2023, <https://www.economist.com/finance-and-economics/2023/03/30/how-rare-gas-supply-adapted-to-russias-war>.

2 Russian trade developments

Since Russia's central bank stopped publishing detailed foreign trade data after Russia invaded Ukraine, Darvas and Martins (2022) reconstructed data on Russia's foreign trade based on the bilateral statistics published by the statistical offices or trade ministries of 34 countries: 27 European Union countries, China, the United States, South Korea, Japan, India, the United Kingdom, and Turkey. We have updated the dataset until March 2023 and included Brazil, Switzerland, and Norway too. These 37 countries accounted for around 77 % of Russia's exports, imports and trade surplus in 2019.

2.1 Russian exports

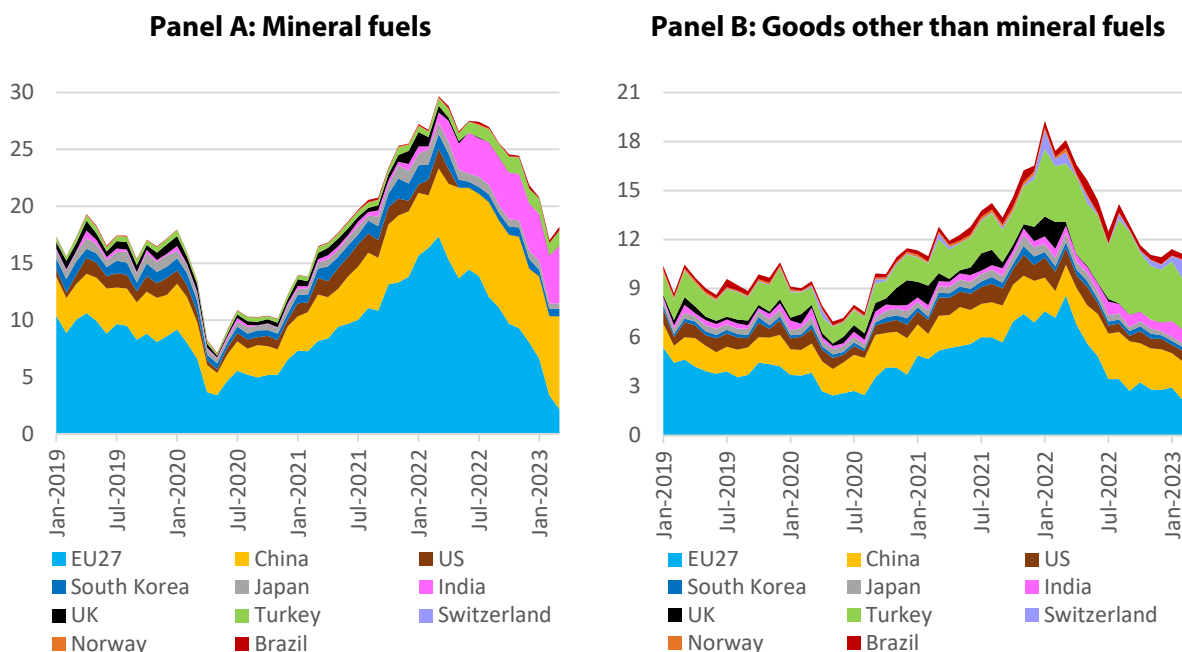
Mineral fuels (coal, gas, petroleum, and related products) dominate Russia's exports, and thus we separately report Russia's mineral fuel exports from other goods (Figure 4). The data is in current price USD because volume statistics are not available for most data sources. Thus, the values reported reflect both quantity and price changes.

With the global outbreak of the COVID-19 pandemic, Russian mineral fuel exports to the 37 countries fell to less than half the average monthly exports in 2019, due to both quantity (reduced demand for energy) and price (lowered energy prices) effects (Figure 4, Panel A). Since then, Russian mineral fuel exports have steadily increased, contributing to higher Russian revenues, up until March 2022, just after the start of the war. This rise reflects both quantity and price effects.

Since March 2022, Russia's mineral fuel exports to the EU have declined in value (from USD 17.4 billion in March 2022 to USD 2.2 billion in March 2023) and as a share of total Russian mineral fuels exports to the 37 countries (from 59 % in March 2022 to 12 % in March 2023). In January 2023, China overtook the EU as the most important market for Russia's fossil fuels. India and Turkey have also increased mineral fuel imports from Russia since the full-scale war began. The US and the UK have phased out Russian-sourced fossil fuels. Mineral fuel imports of Japan and South Korea from Russia declined substantially since the start of the war (by 52 % in the case of Japan and 49 % in the case of Korea), but the general decline was occasionally interrupted by increases.

The EU's decoupling from Russia is also reflected in the spectacular fall in Russian exports of goods other than mineral fuels to the EU: from USD 8.6 billion in March 2022 to close to USD 3 billion in late summer 2022, with further slower declines to close to USD 2 billion as of March 2023. Turkey became a larger market for Russian goods other than mineral fuels than the EU. China and India also increased such imports from Russia, while the US, UK, Japan, and South Korea reduced their Russian imports (Figure 4, Panel B).

Concerning the aggregate of the 37 countries, among the different Standard International Trade Classification (STIC) level-1 categories of goods, a large drop, 46 % and 34 %, was observed for Russian exports of 'material manufactures' and 'miscellaneous manufactures', respectively, while 'machinery and transport equipment' fell by 20 % from February 2022 to March 2023. These declines might suggest that the war and the various sanctions imposed have already started to damage the productive capacity of the Russian economy. The drop in chemicals was 18 % and the drop in crude materials (not including mineral fuels) was 12 %. Russian exports of 'food and live animals' and 'animal and vegetable oils and fats' have experienced an increase of 20 % and 15 %, respectively, in March 2023 compared to February 2022.

Figure 4: Russia's exports to 37 countries, January 2019 – March 2023 (USD billions)

Source: Bruegel based on Eurostat, General Administration of Customs – People's Republic of China, United States Census Bureau, Korea Customs Service, Ministry of Finance – Trade Statistics of Japan, Ministry of Commerce and Industry – Government of India, Office of National Statistics (UK), Turkish Statistical Institute, Swiss Federal Office for Customs and Border Security, Statistics Norway, Comex Stat (Brazil).

2.2 Russian imports

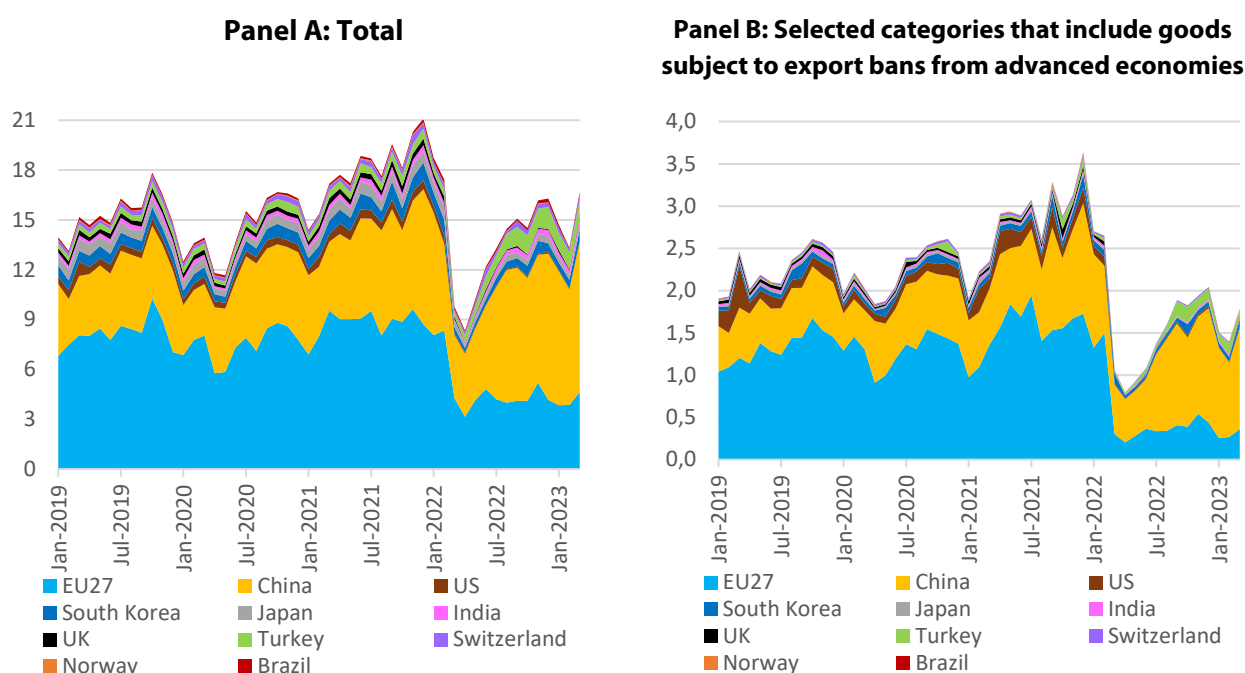
There was a dramatic drop in Russian imports when the full-scale war began: the initial drop was slightly more than 50 %, followed by a recovery characterised by trade diversion (Figure 5, Panel A). Imports from the EU remained less than half compared to the average in 2021, while imports from China recovered to pre-war values, having even surpassed those values in March 2023. The momentum of Russian import recovery from China was not monotonic, though, with the February 2023 data turning out to be the lowest since August 2022. The strongest recovery was seen in Russian imports from Turkey, which, starting from a low level, more than doubled the pre-war values by autumn of 2022. Russian imports from India reached approximately pre-war levels, though the amount of Russian imports from India is rather small.

Concerning all 37 countries and SITC level-1 categories, the largest decline was for Russian imports of 'material manufactures' and 'machinery & transport equipment', which were around 14 % lower in March 2023 than before the war. This could partially reflect the impact of sanctions that prohibited exports to Russia of strategic goods, including high-tech goods and components for use in electronics, telecommunications, aerospace, and oil refining, by several countries. US sanctions apply not only to goods exported by US companies but also to goods produced elsewhere using US technologies, which likely constrained exporters from China and other countries that did not impose sanctions. Unfortunately, it is not possible to exactly track sanction products using aggregate trade statistics, because, for most countries, only higher-level aggregates are available. Nevertheless, we selected five 2-digit level SITC categories, which could be dominated by sanctioned items, though these surely include non-sanctioned items as well. The five categories are: (1) Electric machinery and parts (including semiconductors), (2) Instruments and apparatus (including lasers), (3) Office and automatic data-processing machines, (4) Telecommunications and sound recording equipment, (5) Transport equipment (other than road vehicles).

Figure 5 shows a much larger drop in Russian imports of these five categories (Panel B) than the drop in total Russian imports (Panel A). This suggests that sanctions have influenced trade flows. Strikingly, Russia's imports of the five product categories from the EU, US, UK, Japan, South Korea, Switzerland and Norway, which imposed sanctions, declined massively after February 2022, by 73 % from February 2022 to March 2023. Russian imports of the same five product categories from China fell by about one-half after February 2022, but recovered close to the pre-war levels already by the summer of 2022. Similarly to the lack of a clear trend of Russian imports from China after September 2022, the imports of these five product categories did not increase much further since September 2022. The February 2023 value was well below the values observed before the war, but there was a recovery in March 2023.

All these findings suggest that suppliers from China, but also from India and Turkey, were not able to fill the gap from the loss of Western producers.

Figure 5: Russia's imports from 37 countries, January 2019 to March 2023 (USD billions)



Source: Bruegel based on Eurostat, General Administration of Customs – People's Republic of China, United States Census Bureau, Korea Customs Service, Ministry of Finance – Trade Statistics of Japan, Ministry of Commerce and Industry – Government of India, Office of National Statistics (UK), Turkish Statistical Institute, Swiss Federal Office for Customs and Border Security, Statistics Norway, Comex Stat (Brazil). Notes: panel B shows the aggregate of the following five STIC level-2 categories: Electric machinery and parts (including semiconductors); Instruments and apparatus (including lasers); Office and automatic data-processing machines; Telecommunications and sound recording equipment; Transport equipment (other than road vehicles).

However, there are signs of circumvention of EU export bans. In the second briefing paper of this series (Darvas *et al*, 2023), we found that EU exports of manufacturing goods to Armenia, Kazakhstan, and Kyrgyzstan increased rapidly since the full-scale invasion started. These three countries, along with Russia and Belarus, form the Eurasian Economic Union, which includes a common trade area with free movement of goods within the five countries and a common external customs border. Increased EU manufacturing exports to these three countries compensated for about 30 % of the decline in EU manufacturing exports to Russia in the half-year period of September 2022-February 2023 compared to the half-year period a year earlier, September 2021-February 2022. While the three countries might wish to import more from the EU if they can get fewer manufacturing products from Russia due to the decline of Russian manufacturing production, the very large increase in EU exports to these three countries makes this possible explanation unlikely the main driver of EU export increases. It is more likely that certain EU companies falsely declare

the three countries as the destination of their exports, when the shipment actually goes to Russia. Furthermore, when comparing the amount of goods the EU reports to export to these three countries and the amount of imports these countries report to receive from the EU, Cook et al (2023) conclude that only about half of a USD 2 billion sample of controlled dual-use items shipped from the EU actually reached their stated destinations in Kazakhstan, Kyrgyzstan and Armenia. They hypothesised that Russia had sidestepped EU sanctions by middlemen, agents or suppliers putting fake destinations on EU customs declarations.

Another possible way to circumvent sanctions is re-routing trade via other countries, with products then re-exported from these countries to Russia. By analysing EU exports to China and Turkey and Chinese and Turkish exports to Russia, Darvas and Martins (2022) did not find evidence for that using data up to October 2022.

3 Ukrainian trade developments and further EU support options

3.1 Changes in the direction, composition, and transportation of Ukrainian trade

Since the start of the full-scale war, the geography of Ukrainian trade has changed significantly. The role of the EU as the main trading partner has increased from 36 % in 2021 to 61 % in 2022, due to some increase in Ukrainian exports to the EU and significant declines in exports to other trade partners (blue-coloured numbers in Table 1 indicate the jurisdictions for which Ukrainian export value increased). The share of Asia reduced from 36 % to 24 % and the share of Africa declined from 9 % to 5 %, in 2021 and 2022 respectively (Table 1). The trade with the EU was boosted by trade liberalisation measures and improvement of logistics infrastructure (see below), and geographical closeness helped too. The blocked seaports and a greater distance hindered trade with Asia and Africa.

Already in 2021, the Commonwealth of Independent States (CIS) countries had a relatively small role in Ukraine's exports, at around 11 %, but this further decreased to 6 % in 2022. The latter numbers reflect the full embargo introduced by Ukraine on trade with Russia after the full-scale invasion. The non-zero figures on trade with Russia in 2022 are due to trade that still took place in January and February before the invasion. Ukrainian exports to Belarus, another CIS country, decreased by 87 % as compared to 2021.

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Table 1: Ukraine's trade of goods in 2021 and 2022 (USD billion and percent of total)

	2021 (USD)	2022 (USD)	2021 (share)	2022 (share)
Total exports	63.1	40.9	100 %	100 %
EU	22.9	24.8	36.2 %	60.7 %
Asia	22.9	9.6	36.4 %	23.5 %
Africa	5.6	2.1	8.9 %	5.2 %
CIS	6.7	2.3	10.7 %	5.6 %
America	3.2	1.2	5.1 %	2.9 %
Countries				
Poland	4.4	6.0	6.9 %	14.6 %
Romania	1.2	3.6	1.9 %	8.9 %
Hungary	0.6	1.4	1.0 %	3.3 %
Slovakia	0.9	1.4	1.5 %	3.5 %
Bulgaria	0.8	1.4	1.3 %	3.5 %
Germany	2.3	1.8	3.6 %	4.4 %
Italy	3.3	1.6	5.3 %	3.9 %
Turkey	4.0	2.9	6.4 %	7.1 %
China	7.9	2.5	12.5 %	6.0 %
India	2.5	0.9	3.9 %	2.2 %
US	1.6	0.9	2.5 %	2.1 %
Russia	2.7	0.3	4.3 %	0.8 %
Belarus	1.5	0.2	2.4 %	0.5 %
Total imports	69.8	56.2	100 %	100 %

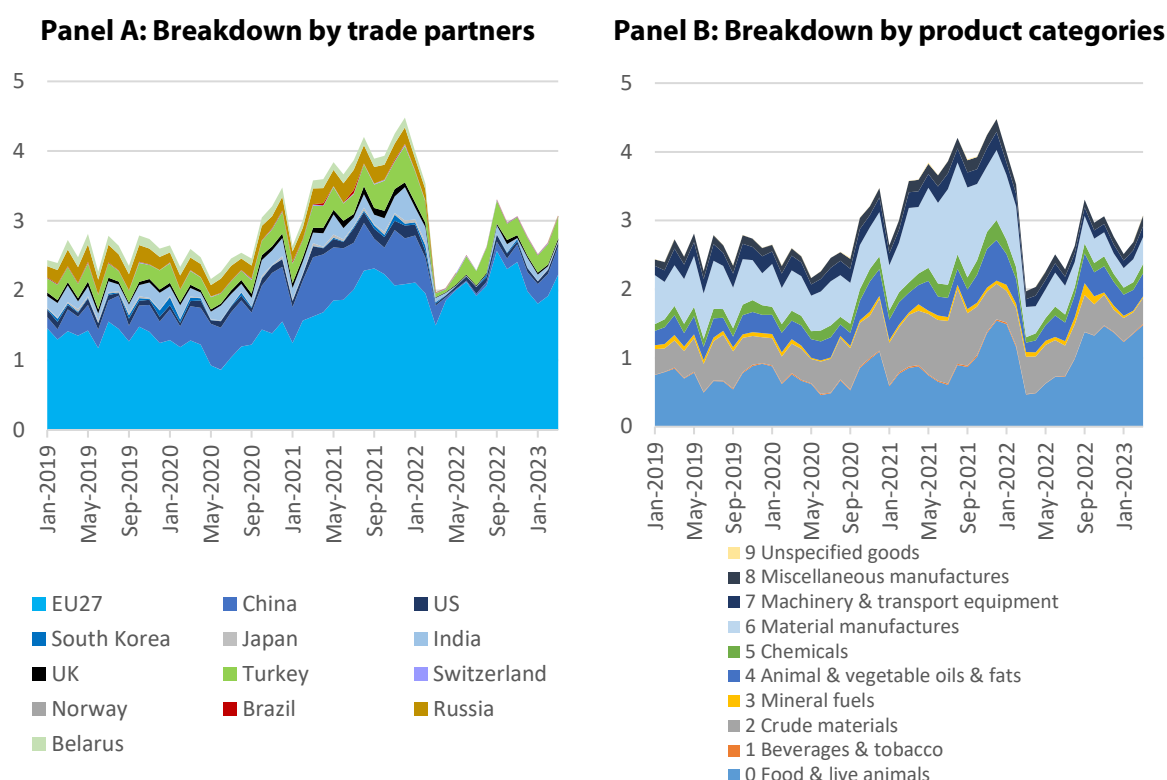
Source: National Bank of Ukraine (https://bank.gov.ua/files/ES/Tov_y_en.xlsx).

Notes: The countries in blue have experienced an increase in absolute value exports from 2021 to 2022.

Monthly data from Ukrainian official statistics demonstrates that after an initial drop when the full-scale war began, Ukrainian exports to the EU more than recovered compared to pre-war levels, while exports to China, which was the second largest market for Ukrainian products after the EU, just marginally recovered (Figure 6). As for product categories, exports of agricultural products and crude materials recovered close to pre-war values and accounted for an average of 69 % of exports in the second half of 2022 versus 51 % in 2021⁵. Ukrainian exports of material manufactures, whose main components are iron and steel, had a sharp decline.

⁵ This considers SITC 1-digit categories '0 Food and live animals', whose largest category is cereals, and '2 Crude materials', that includes oil seeds, and '4 Animal & vegetable oils and fats'.

Figure 6: Ukrainian exports of goods by trade partners and product categories to 39 countries, January 2019–March 2023 (USD billion)



Source: Bruegel based Ukrainian Official Statistics. Notes: The product categories correspond to SITC 1-digit categories

To gain further insights into the challenges of Ukrainian trade, we conducted interviews with Sergiy Nikolaychuk (Deputy Governor of the National Bank of Ukraine), Svitlana Taran (Head of Trade+, International Trade Research Center, Kyiv School of Economics), Mariia Bogonos (Head of the Center for Food and Land Use Research, Kyiv School of Economics) and Pavlo Martyshev (Researcher at the Center for Food and Land Use Research, Kyiv School of Economics). We are grateful to them for sharing their time and expertise with us.

The interviewees explained that the metals industry suffered a high level of destruction in Ukraine, since a lot of production capacity was located in territories affected by the full-scale war, especially Mariupol, which reduced Ukrainian exports of related products.

Before 2022, more than 60 % of all goods exports were delivered via seaports. Transportation of food products was particularly dependent on seaports (99 % for grains, 91 % for sunflower oil, 85 % for oilseeds). Since then, there has been a considerable change in the transportation means used for trade, especially due to the blockade of most seaports. The interviewees indicated that between March and December 2022, around two-thirds of trade in food products was delivered by sea routes, 22 % via railways and 11 % delivered via automotive transportation.

Given the importance of Ukrainian food exports to the world, several measures have been taken to facilitate primarily the exports of agricultural products. The grain corridor (formally Black Sea Grain Initiative⁶), negotiated with Russia and intermediated by the United Nations and Turkey, has been important in expediting some agricultural goods via sea. However, it is limited to that category of goods

⁶ Official UN page of the initiative: <https://www.un.org/en/black-sea-grain-initiative>. And additional explanations and statistics provided by the European Council and Council of the EU: <https://www.consilium.europa.eu/en/infographics/ukrainian-grain-exports-explained/>

and fertilisers, transportation became more expensive and complicated – not least due to the thorough inspection of the ships – and the duration of the agreement, first established in July 2022, is subject to regular negotiations and uncertainty. The hardship and uncertainty surrounding such negotiations are evident in the outcome of the latest extension negotiations in March 2023, with the Russian spokesperson indicating an extension of 60 days, while Ukraine and Turkey reported the extension would be of 120 days⁷.

The threat that blockades in many ports posed to global food security led the EU to take prompt action by establishing Solidarity Lanes to address transport bottlenecks in May 2022, even before the Black Sea Grain Initiative. The goal was to put in place additional freight rolling stock, vessels and lorries, increase the capacity of transport networks and transshipment terminals, speed up customs operations and other inspections, and provide storage of goods on the territory of the EU⁸. While the attention has been primarily on agricultural products, other Ukrainian goods (e.g., ores, iron and steel, earth, wood) have also been benefiting from these lanes. According to recent information⁹, these solidarity lanes have already contributed to generating EUR 20 billion for Ukrainian farmers and businesses.

Alongside the Solidarity Lanes, EU initiatives included trade liberalisation measures¹⁰. The EU suspended all tariff quotas, tariffs, and trade defence measures on Ukrainian goods that had not yet been liberalised under the deep and comprehensive free trade area (DCFTA), including agri-food and metal products. Another important measure was the EU-Ukraine transport agreement¹¹, which liberalised transit and bilateral international carriage operations between the EU and Ukraine, including the suspension of the requirement for an international permit for Ukrainian carriers for bilateral transport and transit to the EU. These measures have proven very effective in supporting Ukraine's exports. As one of the interviewees noted, *"the volume of cargo transportation and the number of carriers has increased by more than 50 % in 2022¹². After signing the agreement in June 2022, the number of carriers crossing the border to the EU increased by 53 % compared to the same period in 2021¹³."* It is worth noting the intensification of trade in the Danube ports, especially cargo flow of agricultural products to Romania¹⁴, which is expected to be expanded to more product categories¹⁵.

However, the massive inflow of Ukrainian food products, and in particular cereals, is putting downward pressure on the prices of these commodities in EU countries, which has already triggered reactions in some central and eastern EU countries. Throughout April 2023, Bulgaria, Hungary, Poland and Slovakia imposed unilateral restrictive measures on imports of Ukrainian agricultural products with the aim of protecting their own farmers, while Romania was considering similar measures. In late April 2023, a deal was reached by the European Commission and the five countries to allow Ukrainian food products to cross these countries, while EUR 100 million from the agricultural reserve for 2023 will be directed to farmers producing

⁷ <https://www.npr.org/2023/03/18/1164538947/russia-ukraine-grain-deal-extended>

⁸ https://transport.ec.europa.eu/news-events/news/european-commission-establish-solidarity-lanes-help-ukraine-export-agricultural-goods-2022-05-12_en

⁹ https://ec.europa.eu/commission/presscorner/detail/en/fs_22_6862

¹⁰ Press release Council of the EU: <https://www.consilium.europa.eu/en/press/press-releases/2022/05/24/ukraine-council-adopts-temporary-trade-liberalisation-with-ukraine/>. An extension of these measures is being considered: https://ec.europa.eu/commission/presscorner/detail/en/ip_23_1023

¹¹ https://transport.ec.europa.eu/system/files/2022-06/Agreement_EU_Ukraine_carriage_of_freight_by_road.pdf

¹² <https://www.kmu.gov.ua/en/news/ukrainskym-pereviznykam-i-nadali-ne-potribni-dozvoly-dlia-dvostoronnikh-i-tranzhytnykh-perevezhen-do-krain-ies-premier-ministr>

¹³ <https://eba.com.ua/en/advocacy-diary/success/470336-2023-03-16-15-35/>

¹⁴ News article referring to increased activity in June 2022:

<https://lloydslist.maritimeintelligence.informa.com/LL1141204/Ukraines-Danube-ports-increase-activity-to-boost-grain-trade>

¹⁵ Danube's Commission official website with what has been achieved and future plans, namely under the EU-Ukraine Solidarity Lanes: <https://www.danubecommission.org/dc/en/2023/03/08/the-danube-commission-continues-to-find-solutions-to-improve-existing-iwt-logistics-and-the-traffic-on-the-lower-danube/>

cereals and oilseeds in these five frontline countries¹⁶. The agricultural ministers of twelve other EU countries expressed concerns about the deal¹⁷.

On the import side, the biggest issue the war posed was on petroleum products since around 60 % was coming from Russia and Belarus. Ukraine had to redirect its imports of these products swiftly and is now importing from EU countries and a few others. Also, given the war situation, it is natural that Ukraine imported more war equipment, which also increased the weight of such equipment in total Ukrainian imports.

When asked about how Ukrainian companies could adapt so fast in terms of trading relations, especially in view of the cut in relations with Russia, interviewees pointed out that trade with Russia had already decreased significantly since 2014, after the Crimea annexation and armed aggression of Russia in eastern Ukraine, so now the adjustment was easier. In fact, Ukrainian companies were more prepared for such a disruption than many EU companies that were heavily dependent on relations with Russia.

Still, despite all the support measures aforementioned, according to April 2023 estimates, Ukraine's agriculture has lost about USD 40 billion, which includes agricultural damages in machinery and storage facilities, indirect losses, including lower production of crops and livestock, as well as logistics disruptions and higher production costs (Kyiv School of Economics, 2023). In 2021, Ukrainian exports of agricultural commodities accounted for around USD 28 billion, so the loss is greater than what was produced in 2021, even though it is important to keep in mind that commodity prices have increased since then.

Also, interviewees highlighted that Ukrainian producers are not only suffer from physical damages to production facilities and infrastructure, labour force decline and high security risks, but are also financially constrained. Access to credit is very limited and bank interest rates are in the order of 30 % annually. To address some of these difficulties, public programmes supporting the purchase of seeds have been important.

3.2 Barriers and market opportunities

Ukrainian experts we interviewed identified various barriers and pointed out areas where further support is needed. First, as mentioned previously, the seaport blockade presents a critical barrier to Ukrainian trade. As trade routes and transportation modes adapt to this new reality, a lot still needs to be done to make trade smoother and more efficient. Moreover, it is important to expand transportation by the grain corridor to other goods and other seaports.

There are currently two types of bottlenecks with land transportation to the EU. First, procedures at the EU borders are still suboptimal, with slow customs procedures due to the high volume of merchandise to check and limited personnel capacity, resulting in long queues and waiting times for products to be cleared and cross the border. Second, differences in transport infrastructure, especially for railways which have incompatible rail gauge widths, mean that wagons cannot easily cross the border, with wheels needing to be changed. This makes the process slow and inefficient. The EU is aware of these challenges and is working to address them¹⁸.

Hence, future efforts should be put into place to improve customs procedures at the border and to harmonise transport infrastructure to address bottlenecks. To this end, public investments in logistic infrastructure would be very important and offer benefits for both Ukraine and the EU.

¹⁶ https://agriculture.ec.europa.eu/news/eu100-million-support-farmers-bulgaria-hungary-poland-romania-and-slovakia-2023-05-03_en

¹⁷ <https://www.politico.eu/article/dozen-eu-countries-blast-deal-to-restrict-ukrainian-grain-russia-war/>

¹⁸ See section "Urgent action to address transport bottlenecks": https://transport.ec.europa.eu/news/european-commission-establish-solidarity-lanes-help-ukraine-export-agricultural-goods-2022-05-12_en

Additionally, strengthening public-private partnerships to boost and stimulate private capital inflows to Ukraine could be very useful to its economy and especially later during the recovery and reconstruction in the aftermath of the war. Due to heightened (partly military) risks, possible guarantees by EU entities, like export credit agencies, could boost private capital flows into the Ukrainian economy. It was also noted that the large scale of emigration to escape the war resulted in a large outflow of capital from the country, which would be important to be brought back.

EU schemes supporting trade financing to Ukrainian companies would be similarly helpful, not least because most Ukrainian importers are requested to pay in advance, due to the heightened risk of whether Ukrainian importers would be able to pay.

Finally, extending the trade liberalisation measures by at least one more year would be crucial.

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BRIEFING

The trade and investment sanctions imposed by the EU and other countries on Russia following the war of aggression

ABSTRACT

This briefing provides an overview of the sanctions imposed by the EU and other nations (Australia, Canada, Japan, Korea, the UK and the USA). It analyses the sanction effects accumulated so far and their impact, including the EU's decoupling process from Russian energy and explanations for the less-than-initially expected contraction of the Russian economy in 2022. The paper analyses the short, medium and long-term effects of the sanctions on the economies of the EU, Russia and Ukraine.

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Executive summary

The EU imposed ten wide-ranging sanction packages on Russia. Trade-related sanctions included export bans of strategic goods to Russia, such as high-tech goods and components for use in electronics, telecommunications, aerospace and oil refining, among other sectors. The EU banned imports of Russian coal from August 2022, seaborne crude oil from December 2022, and refined petroleum products from February 2023. Other developed nations imposed similar sanctions on Russia.

International trade data from Eurostat suggests that EU manufacturing exports to Russia declined significantly, but increased exports to Armenia, Kazakhstan and Kyrgyzstan (countries that share a common trade area with Russia) compensated for about 30 % of the decline. This suggests the circumvention of EU export ban sanctions, which requires improved policy action.

The EU economy has shown remarkable resilience to an energy shock in the past 12 months. Fiscal support, a significant reduction in energy demand by households and businesses, and favourable global conditions of energy demand, particularly gas, have helped in sustaining the economic cost. Price inflation, on the hand, has reached unprecedented levels. Initially, inflation was, for the most part, cost-led, but more recently core inflation became persistent.

The Ukraine economy has shrunk by 35 % in 2022, setting it back 15 years. However, the economy has been stabilised, and positive growth is expected for 2023. The country requires a sustained balance of payments assistance and, eventually, a plan for reconstructing the extensive damage to its capital stock.

Russia's economy declined by only 2 % in 2022, despite earlier expectations for bigger declines. This is primarily because the first EU sanction on Russian energy only came into force on 5 December 2022. Since the EU's import embargos on Russian oil entered into force, the EU has made big progress towards decoupling from Russia. Sanctions will worsen an already weak prospect of Russian potential growth.

1 Introduction

The objective of this paper is to summarise the sanctions that have been imposed on Russia both by the EU and other jurisdictions around the world, and to provide an assessment of the impact on the economies of Russia, the EU, and Ukraine. However, isolating the direct impacts of the sanctions from the more general impacts of the war and other non-sanction-related developments is a difficult task. Petroleum and gas prices started to increase already in 2021, well before the war started, due to both demand factors (such as the recovery from the pandemic) and supply factors (Russia started to reduce its gas exports to the EU from mid-2021, while severe drought compromised hydropower generation, and French nuclear power plants suffered from corrosion problems, which increased the need for gas-powered electricity generation). Thus, whenever it is possible, we aim to evaluate the direct impact of sanctions, but in most of this briefing paper, we explore the short-run and the possible long-run economic implications of the full-scale Russian invasion of Ukraine which started in February 2022.

2 Overview of the ten EU sanction packages

The EU imposed trade, energy, and financial sanctions on Russia since the annexation of Crimea in 2014. In response to the full-scale Russian invasion of Ukraine in February 2022, 10 EU sanctions packages have been approved by the time of writing¹.

¹ See also 'Facts and figures about EU-Russia Relations' at https://www.eeas.europa.eu/sites/default/files/eeas-eu-russia_relation-en_2021-07.pdf

Sanctions 2014–2022

The EU imposed sanctions and other restrictive measures on the Russian Federation following the annexation of Crimea in March 2014. Immediate sanctions in response to the annexation involved asset freezes and travel bans on individuals.ⁱ

The EU imposed trade and financial sanctions throughout the summer of 2014 in response to the annexation and events in the Donbas, notably the shooting down of Malaysia Airlines Flight 17 on 17 July 2014. Sanctions imposed included import bans on goods that originated from Crimeaⁱⁱ and measures targeting Russia's military and technological capabilities, such as embargos on trades in weapons and export bans for dual-use goods for military end users.ⁱⁱⁱ Sanctions also focused on energy, including restrictions on exports of technology for oil exploration.^{iv} EU financial sanctions limited access to EU capital markets for Russian state-owned financial institutions and halted EIB and EBRD financing^v, and banned the purchase or selling of Russian bonds, equity or similar instruments with a maturity greater than 90 days.^{vi}

In 2015, the EU decided to renew the sanctions every six months until Russia fully implemented the Minsk Agreements, which they never did.^{vii} From 2015 – February 2022, sanctions were renewed, with individual and entity sanctions imposed intermittently for various reasons related to Ukraine's territorial integrity (e.g. see sanctions following November 2018 Donbas "elections")^{viii}.

The massive military invasion since 24 February 2022 triggered the imposition of unprecedented sanctions. In addition to the trade, energy and financial sanctions explained below, sanctions on individuals and entities have been announced continuously following the EU, G7 and Australia *Russian Elites, Proxies, and Oligarchs* (REPO) multilateral task force announced in March 2022^{ix}, which as of 9 March 2023 had blocked or frozen more than USD 58 billion worth of sanctioned Russians' assets.^x

First package: 23 February 2022^{xi}

One day before the invasion, the EU adopted sanctions in response to Russia's recognition of Donetsk and Luhansk as independent entities. Trade sanctions targeted the Donetsk and Luhansk regions, banning imports, restricting trade and investments related to certain economic sectors and banning exports of certain goods and technologies related to transport, telecommunications and energy (see the complete list in Annex II of Council Regulation 2022/263)^{xii}. The EU also imposed broader financial sanctions, including a prohibition to finance or deal with transferable securities and money-market instruments of the Russian government and Central Bank after 9 March 2022.^{xiii}

Second package: 25 February 2022^{xiv}

New financial sanctions removed Russian access to more important capital markets and banned listing of and services to Russian state-owned entities on EU trading venues. Sanctions also attempted to limit Russian financial inflows to the EU by banning the acceptance of Russian deposits above certain values and the selling of euro-denominated securities to Russian clients. Trade restrictions in this package continued to focus on energy, technology, and transport. Export bans focused on goods and technologies for oil refining, aviation manufacturing, dual-use goods and technology and the defence and security sector. Examples include semiconductors and aircraft parts.

Third package: 28 February 2022^{xv} and 2 March 2022^{xvi}

On 28 February, all transactions with the Russian Central Bank were prohibited. The Council imposed further financial restrictions on 2 March, which included a ban on the provision of specialised financial messaging services (SWIFT)² to several Russian Banks, banned participation with Russia's Sovereign Wealth

² This was done in participation with the G7. See Section 2.

Fund in future investments and tightened restrictions on financial inflows by prohibiting to “sell, supply, transfer or export” euro-denominated banknotes to any Russian person or entity.

Between the third and fourth packages, further export measures were made on 9 March to include restrictions on the export of maritime navigation goods and radio communication technology to Russia, as well as extend several of the existing sanctions to Belarus.^{xvii}

Fourth package: 15 March 2022^{xviii}

The EU’s fourth package came after the 11 March commitment with the G7 to take a number of measures against Russia, including banning the export of luxury goods to Russia and banning new investment in the Russian economy (see section 2 for more details). More concretely, in the fourth package, trade restrictions were imposed on luxury goods following the G7 meeting, but also on iron and steel. Further export restrictions were imposed on equipment, technology, and services for Russia’s energy industry, as well as a ban on new investments in the Russian energy sector. Financial measures in the fourth package prohibited transactions with some state-owned enterprises (SOEs) and prohibited the provision of credit rating services.

Fifth package: 8 April 2022^{xix}

Energy sanctions in the fifth package banned imports of Russian coal and other solid fossil fuels from August 2022, imports of which were worth EUR 8 billion a year. Other trade sanctions comprised a ban on exports of an array of goods, including jet fuel, quantum computers and high-end electronics, which accounted for EUR 10 billion euros annually. Import bans accounting for EUR 5.5 billion of yearly trade included wood, cement, and fertilisers. Russian vessels were banned from using EU ports. This package also tried to close loopholes from previous packages in the financial sector, such as including banning the use of crypto-wallets for deposits from Russian entities initially imposed in the second package of sanctions and extending the ban in the third package on the sale of banknotes and transferrable securities to all official currencies of EU member states. Further measures targeted the banking sector, with a ban on transactions with four Russian banks, which represented 23 % of the Russian banking sector’s market share.

Sixth package: 3 June 2022^{xx}

The EU announced phasing out Russian seaborne crude oil imports by 5 December 2022, and petroleum products by 5 February 2023. Exceptions included pipeline imports, plus seaborne crude oil for Bulgaria and Croatia, two countries particularly dependent on Russian oil. Financial sanctions continued with additional de-SWIFTing of banks, including Russia’s largest bank Sberbank. The list of export restrictions continued to expand to include more goods and technologies, including technology related to Russia’s defence and security sector, as well as 80 chemicals which can be used in manufacturing chemical weapons.

Seventh package: 21 July 2022^{xxi}

This so-called *Maintenance and Alignment Package*, aimed to strengthen existing sanctions. It also included Russian gold³ and jewellery import bans, and extended the list of goods that could be recognised as dual-use products and goods which can contribute to Russia’s military or technological advancement.

Eighth package: 6 October 2022^{xxii} – the oil price cap

This package followed the annexation of Donetsk, Luhansk, Zaporizhzhia and Kherson regions in September 2022. In response, import bans were extended to more products, including steel products,

³ This commitment followed the EU + G7 commitment to reduce Russian revenues from selling gold on 27 June 2022. See Section 2.

wood pulp and paper. Finally, the trade sanctions against Donetsk and Luhansk in the first package of sanctions were extended to cover Zaporizhzhia and Kherson.

This package also introduced the legal basis for a price cap on the maritime transport of Russian crude oil and petroleum products to third countries. This followed the announcement of the EU, G7 and Australia on 2 September to implement a price cap on Russian-origin crude oil and petroleum products.^{xxiii} The price cap allows for the maritime transport, technical assistance, brokering services and financial assistance of these products by companies located within the EU or G7, only if crude oil or petroleum products fell below a certain price. The EU agreed on a USD 60 per barrel price cap for crude oil on 3 December 2022, which entered into force on 5 December, and two price caps for petroleum products on 4 February 2023, which entered into force on 5 February 2023. This constituted a price cap of USD 45 per barrel for petroleum products traded at a discount to crude oil (e.g. fuel oil), and a price cap of USD 100 per barrel for petroleum products traded at a premium to crude, such as diesel.^{xxiv} The entering into force of the petroleum product price caps on 5 February 2022 coincided with the EU's import ban of these products as agreed in the sixth package.^{xxv}

Ninth package: 16 December 2022^{xxvi}

This package expanded the list of dual-use goods and technology under export controls meaning that more chemicals, electronics and IT components, amongst others, cannot be traded and contribute to Russia's defence and security sector. Export bans were also imposed on aircraft and drone engines and their parts. Further financial measures included an asset freeze of additional Russian banks, as well as a ban on new investments in the Russian mining sector, with some exceptions for activities involving some critical raw materials.

Tenth package: 25 February 2023^{xxvii}

The latest package continued in the same vein, introducing further export bans on critical technology and industrial goods such as electronics, specialised machine parts and goods for the construction sector such as cranes. Electronic components that have been used in Russian weapons systems, such as thermal cameras and helicopters, were also added to the restricted list. The Council also prohibited the transit through Russia of EU exported dual-use goods and technology. Restrictions on imports of goods which generated significant revenues for Russia, such as asphalt and synthetic rubber were targeted. Finally, this package banned Russian nationals and entities from booking gas capacity in EU gas storage. This measure aims to prevent market manipulation or weaponisation of gas supplies, since there is historical precedent of Russian entities reserving gas capacity that they never used.^{xxviii}

3 Short overview of sanctions imposed on Russia by other third countries

In this section, we focus on the trade, energy and financial sections imposed by Australia, Canada, Japan, South Korea, the USA and the UK.

Trade

In the immediate days following Russia's invasion of Ukraine, Japan^{xxix}, South Korea^{xxx}, the UK^{xxxi} and the USA^{xxxii} promptly announced export controls and bans on various strategic, dual-use and high-tech goods to undermine Russia's military and industrial capacity. Examples include semiconductors (Japan, USA), telecommunications equipment (UK, USA) and navigation equipment (South Korea). Canada followed with similar measures in March.^{xxxiii} Notably, the USA's measures announced on 24 February 2022 included an update to the US's Foreign Direct Product Rule, banning exports of goods from a third country where the underlying technology (e.g. software/blueprints) is American.^{xxxiv} The UK^{xxxv} and USA^{xxxvi} also imposed restrictions on the export of services, such as consultancy and accountancy.

On 11 March 2022, the G7 with Australia committed to revoke Russia's WTO benefits and deny the Most Favoured Nation (MFN) status to imports from Russia.^{xxxvii} This resulted in Canada^{xxxviii} and Australia^{xxxix} both imposing a 35 % general tariff on virtually all imports from Russia, as well as increases in tariffs on certain imports from Russia in the USA,^{xl} UK^{xli} and Japan^{xlii}. The G7 meeting included a commitment to end the export of luxury goods, which Australia also announced on 5 April.^{xliii}

Countries have imposed various import restrictions and bans on metals, most notably the G7 commitment on 27 June to reduce Russian gold imports.^{xliv} In February 2023, the USA^{xlv} put higher tariffs on steel and aluminium imports, and Canada banned aluminium and steel product imports in March.^{xlvi}

Energy

Countries have taken multiple trade measures regarding Russian energy, many predating the G7^{xlvii} commitment to phase out Russian energy imports and key services on 8 May 2022. In March 2022, the USA announced a ban on imports of Russian fuels (oil, LNG and coal), and by May, US imports of Russian mineral fuels had declined to zero (Darvas and Martins, 2022). The UK committed to ending imports of Russian coal and oil by the end of 2022 and gas as soon as possible.^{4, xlviii} In March 2022, Australia^{xlix} banned Russian coal and oil imports, which started on 25 April 2022, and on 10 March 2022 Canada announced import bans on Russian petroleum^l and crude oil imports^{li}. Furthermore, the UK^{lii}, USA^{liii}, Japan^{liv} and Canada^{lv} all took measures to ban any exports of equipment and materials for Russia's oil refining industry.

The G7 and Australia also agreed on a price cap on Russian seaborne crude oil and petroleum products; see a full description under the eighth EU package.

Financial

Shortly after the invasion, the G7 with participation from South Korea^{lvi} and support from Australia^{lvii} committed to excluding Russian banks from the SWIFT messaging system, along with immediate financial measures to prevent the Russian Central Bank deploying international reserves.^{lviii} Immediate actions were taken by the UK^{lix} and Australia^{lx} to restrict access to capital markets. The aforementioned 11 March 2022 G7 summit involved commitments to ban future foreign direct investment (FDI) into Russia as well as preventing Russia from borrowing at multilateral financial institutions (World Bank, IMF).^{lxi} Outward FDI was banned in the UK^{lxii} and USA on 6 April.^{lxiii} On 23 March 2022, the USA, UK and Canada withdrew export finance.^{lxiv}

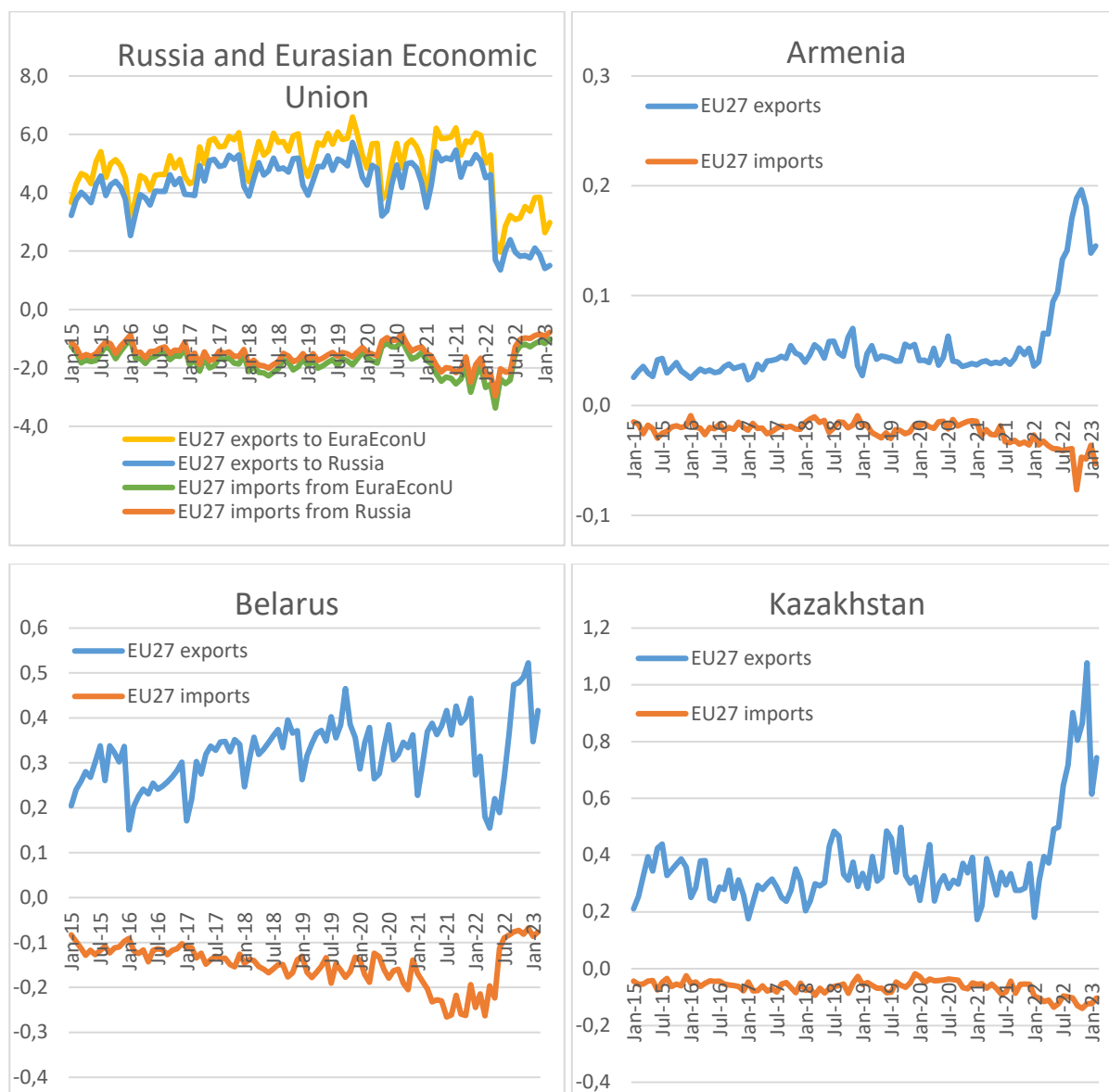
4 Sanction leakage

While sanctions undoubtedly influenced trade flows (see the third briefing paper of this series), various reports suggest circumvention efforts. For example, Cook et al (2023) report that only about half of a USD 2 billion sample of controlled dual use items shipped from the EU actually reached their stated destinations in Kazakhstan, Kyrgyzstan and Armenia. EU exports to these three countries surged since the full-scale invasion started in February 2022. By comparing the amount of goods the EU reports to export to these three countries and the amount of imports these countries report to receive from the EU, Cook et al (2023) outline a growing discrepancy. They hypothesise that Russia has sidestepped EU sanctions by middlemen, agents or suppliers putting fake destinations on EU customs declarations.

⁴ UK gas imports from Russia fell to zero from April 2022, coal imports from Russia were zero in August-November 2022 and since January 2023, with a minor import in December 2022, and petroleum import from Russia was zero or marginal in June-November 2022 and zero from December 2022. See Figure 5 of Bruegel's Russian Foreign Trade Tracker: <https://www.bruegel.org/dataset/russian-foreign-trade-tracker>

Matching the list of dual-used items, which are listed in a 317-page long annex of Regulation (EU) 2021/821⁵, with usual trade codes like HS and STIC is a non-trivial task. We therefore report trade data on all manufacturing goods between the European Union and the Eurasian Economic Union^{6,7} countries (Figure 1).

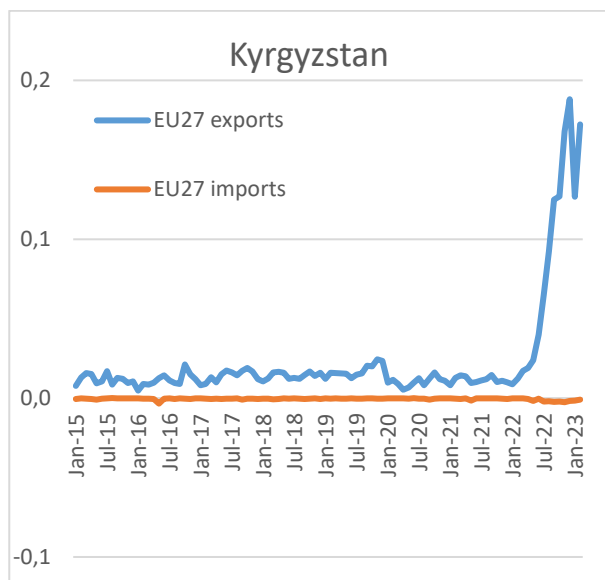
Figure 1: Trade of manufacturing products between the European Union and Eurasian Union countries, January 2015–February 2023 (EUR billions)



⁵ Regulation (EU) 2021/821 of the European Parliament and of the Council of 20 May 2021 setting up a Union regime for the control of exports, brokering, technical assistance, transit and transfer of dual-use items, available at: <https://eur-lex.europa.eu/eli/reg/2021/821/oj/eng>

⁶ The Eurasian Economic Union provides for the free movement of goods, services, capital and labour within its five member countries and pursues coordinated and harmonized policies in various areas. It involves a customs union (no internal customs and common external tariffs).

⁷ EU countries also report increased manufacturing exports to Georgia, from about EUR 100 million a month on average in 2015-2021 to about 200 million by the end of 2022. EU manufacturing exports to Tajikistan and Turkmenistan remained broadly unchanged, while EU exports to Uzbekistan surged in March 2022 and December 2022, but in other months of 2022, as well as in January-February 2023, they remained similar to historical values.



Source: Bruegel based on Eurostat's 'EU trade since 1999 by SITC' dataset.

Note: values refer to three main SITC level-1 categories: 'Manufactured goods classified chiefly by material', 'Machinery and transport equipment' and 'Miscellaneous manufactured articles'.

The rapid increase in EU's manufacturing exports to Kazakhstan, Armenia and Kyrgyzstan is eye-catching. Among these three countries, EU exports to Kazakhstan is sizeable and increased from about 200-400 million euros a month in 2015-2021 to about 1 billion euros in late 2022.

In the 6-month period of September 2021–February 2022, EU27 manufacturing export to Russia was EUR 29.5 billion, which fell to 10.5 billion a year later in the 6-month period of September 2022–February 2023, a fall by EUR 19.0 billion. When considering all 5 countries of the Eurasian Economic Union, EU exports fell from 33.8 billion to 20.2 billion over the same periods, i.e. a fall of 13.7 billion. Thus, increased exports to Armenia, Kazakhstan and Kyrgyzstan account for about 30 % of the fall in EU exports to Russia. The sharp increase in EU exports to these countries could reflect sanction leakage, which requires policy actions.⁸

In February 2023, the EU banned dual-use goods from transiting through Russia, implying that such goods cannot enter Russia directly from the EU, even if the ultimate destination is another country⁹. The key question is whether such a ban, along with efforts to limit re-exports to Russia from third countries, would be sufficient to curb sanction circumvention.

In May 2023, details of the contents of the Commission's proposal for an 11th sanctions package were announced by President von der Leyen. This package proposes a new tool to sanction exports of goods to third countries which end up in Russia, and a ban on 'shadow' entities from Russia and third countries that circumvent EU sanctions.¹⁰

⁸ An alternative explanation for the increased imports from the EU of the three countries could be that the decline of Russian manufacturing production in 2022 resulted in reduced Russian exports to these countries, so these countries had to increase their imports from other countries, including the EU. However, the very large increase in EU exports to these three countries makes this possible explanation unlikely.

⁹ See articles 2(1a) and 2aa(1a) added by EU Regulation 2023/427 in the amendment to EU Regulation 2014/833, 25 February 2023, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32023R0427>.

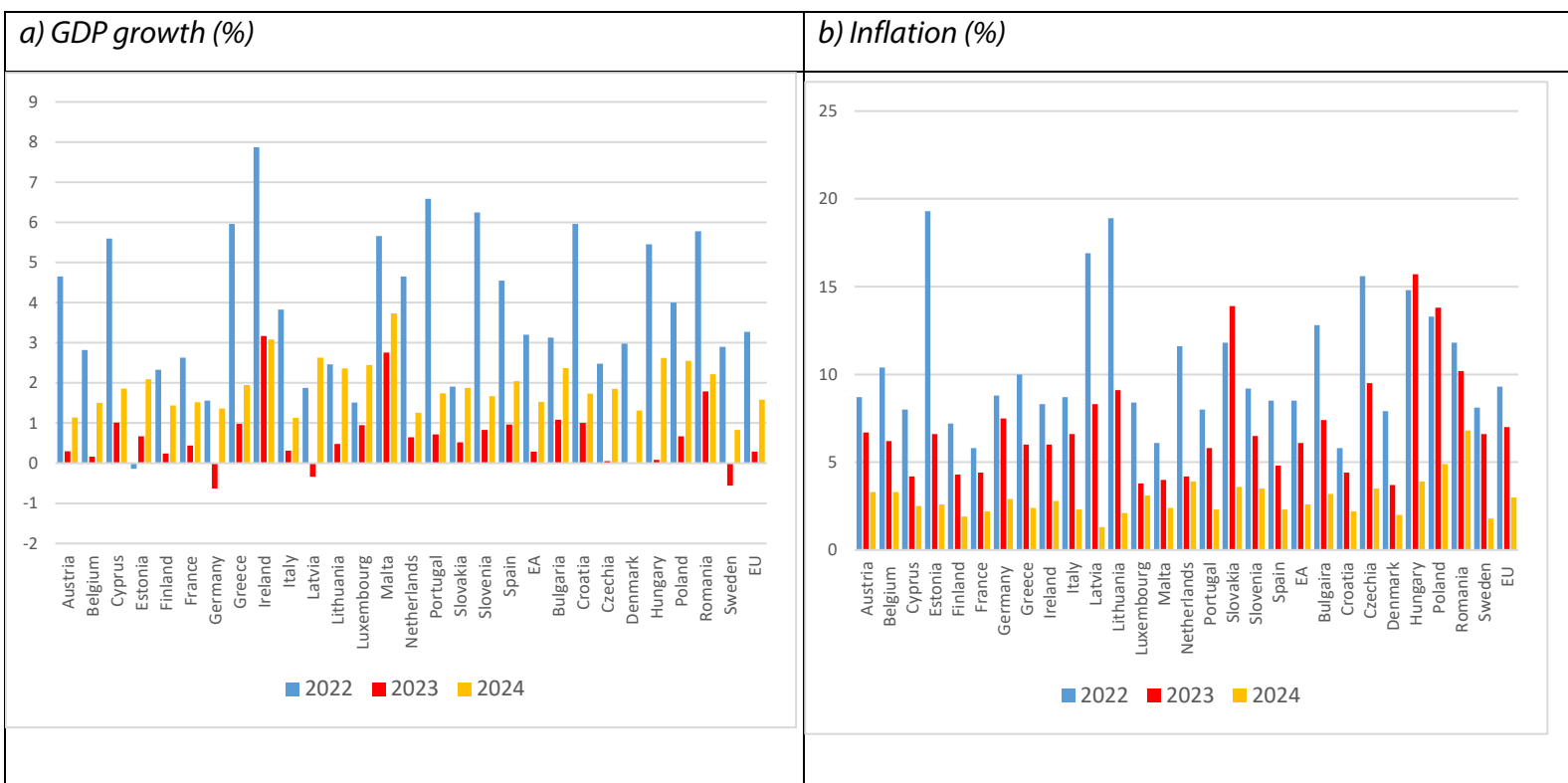
¹⁰ European Commission, 'Press statement by President von der Leyen with Ukrainian President Zelenskyy', 9 May 2023, https://ec.europa.eu/commission/presscorner/detail/en/statement_23_2661

5 Overview of the short-term economic effects of the sanctions on Russia from the EU/Ukraine/Russia perspective

The impact of the Russian invasion of Ukraine on the EU economy

The Russian invasion of Ukraine has had a visible impact on the recovery in the EU coming out of the pandemic crisis. While GDP growth was on average above 3 % for 2022 (Figure 2a), growth is forecast to be close to zero in 2023 and about 1.5 % in 2024.

Figure 2: GDP and inflation in EU countries



Source: European Commission, Autumn 2022 forecasts

The European economy has shown remarkable resilience to what was feared would be a very grave shock. Indicatively, new jobs were generated in 2022 and unemployment remained at an all-time low. Several factors account for this resilience.

First, following the pandemic and energy crises, there has been a very sizable policy stimulus, both from national fiscal authorities¹¹, as well as from the creation of the NextGen EU fund¹². Together with a sizeable provision of liquidity by the European Central Bank (ECB) for the euro area, there was a significant attempt to sustain demand. Most of the pandemic-related discretionary fiscal spending remained in place in 2022 and additional fiscal resources were mobilised to dampen the impacts of high energy prices on households and businesses. While the ECB started to increase its interest rates in July 2022, by then, inflation had reached 9%, and real interest rates (calculated on the basis of both past inflation and inflationary expectations) remained negative, suggesting that monetary policy remained accommodative in 2022.

¹¹ See Bruegel, 'National fiscal policy responses to the energy crisis', <https://www.bruegel.org/dataset/national-policies-shield-consumers-rising-energy-prices> for the national fiscal measures taken during the energy shock and <https://www.bruegel.org/dataset/fiscal-response-economic-fallout-coronavirus> for the measures taken during the pandemic.

¹² See Bruegel, 'European Union countries' recovery and resilience plans', <https://www.bruegel.org/dataset/european-union-countries-recovery-and-resilience-plans>

Second, preliminary evidence by Darvas (2023) indicates the remarkable resilience of the European industry. There was a sizeable reduction in gas consumption by industry, while manufacturing output and employment expanded in 2022. The main industrial sector that suffered from output declines was ‘Electricity, gas, steam and air conditioning supply’, which is not surprising given the lower energy needs in industry and elsewhere in the economy. Last, the fact that China had been in a lockdown for most of last year, has implied that the demand for energy, primarily gas, was not as high as it would have been otherwise. This helped the EU to fill up its storage and smooth the impact of the energy crisis.

However, the big shock to the EU has been high inflation. Average inflation in the EU was 9.6 % in 2022 and is expected to be 7 % in 2023 (Figure 2b). For a couple of countries in central and Eastern Europe, inflation was close to 20 %. Initially, inflation was primarily driven by soaring energy costs, which made the task of controlling inflation difficult for the ECB. However, this is no longer the case with second-round effects causing broad-based price increases in various sectors of the economy. Much uncertainty remains about the duration of these effects and the horizon at which monetary policy can affect them.

Demertzis (2023a) describes some of the consequences of the Russian invasion for the EU. EU countries provided substantial help to households and businesses (collectively amounted to EUR 657 billion). For some countries, the help earmarked for the energy crisis amounted to 9 % in terms of GDP (Slovakia), which naturally put a weight on national debt levels. The EU also paid EUR 140 billion to import energy from Russia in the first 12 months following the invasion of Ukraine. Demertzis and McWilliams (2023) estimate that the EU could pay Russia EUR 29 billion in a baseline scenario in the second 12 months (and between EUR 14 billion and EUR 69 billion, depending on the price and quantity assumptions). While the EU has managed to reduce its energy dependence on Russia, it has not eliminated it. Crude oil dependence, for example, is now 3 %, down from 25 %.

Ukraine – one year at war

Before we can evaluate the economic cost of the Russian invasion, we must acknowledge the tragic human losses. The numbers that are available are probably inaccurate, but there are significant human losses for both military personnel as well as civilians.

What we do know is that over five million refugees from Ukraine are recorded across European countries located west of Ukraine, while about three million people crossed the border with Russia^{lxv}. It is estimated that the effect on the Ukrainian population is very significant; it may decline by as much as a third over the 20 years following the Russian invasion (Kulu et al., 2022).

The World Bank (2022) estimates that in one year, Ukraine has lost 15 years in GDP per capita terms. According to the UN, one in three Ukrainian households is estimated to be food-insecure – in other words, missing essential foods^{lxvi}. (The Ukraine government and Kyiv School of Economics maintain a comprehensive dataset on damages that is continuously updated and verified¹³.)

The Russian economy during 2022

Demertzis et al (2022) note that the Russian economy has not been as much affected by the war as originally anticipated. The April 2023 IMF World Economic Outlook estimates the 2022 contraction in Russian GDP at as just over 2 %, along with 0.9 % average growth in 2023-2028 (IMF, 2023). Not all agree that the picture is quite as rosy^{lxvii}, particularly since data emerging from Russia is no longer reliable. The World Bank (2022) shows that there has not been any increase in the poverty rate and real private consumption has been stable, at similar rates to those before the start of the war.

¹³ See the dataset here: <https://damaged.in.ua/>

The fact remains that Russian revenues have not been affected in a way that would have inhibited its ability to wage war. Three reasons explain that.

Demertzis (2023b) argues that three reasons explain this. First, the EU did not sanction energy for most of 2022. About 8 % of the pre-war export value of Russian energy was under sanctions by third countries. Second, both the fiscal authorities, as well as the Central Bank, were very effective in managing the economy and providing help to households and firms to sustain demand. Third, several countries are either neutral or side with Russia when it comes to this war and are therefore not prepared to cut economic ties. This has allowed Russian to re-direct its economic activities elsewhere in ways that have reduced the impact on its economy. Darvas, Martins and McCaffrey (2023) show that countries, including India, Turkey and China have stepped in to buy Russian energy.

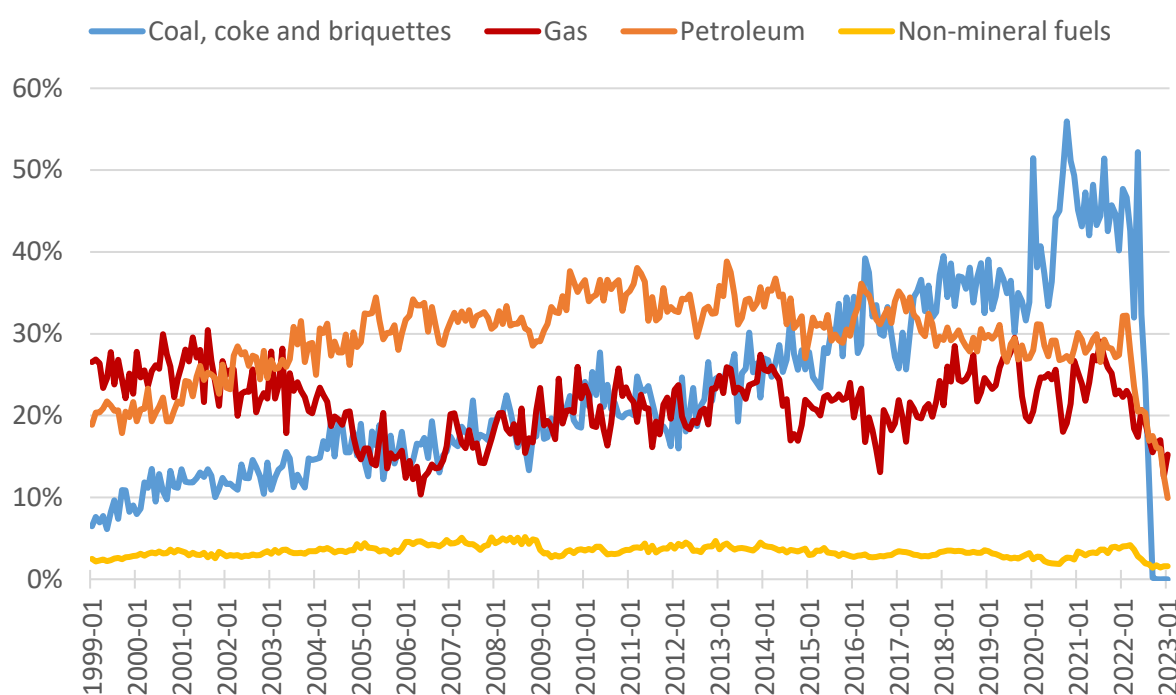
As far as the EU is concerned, McWilliams, Sgaravatti and G. Zachmann (2021) show that only about 20 % of the EU's 2022 imports of natural gas arrived via pipeline, while imports of Russian LNG increased to almost the same level as the reduced pipeline imports.

6 Overview of medium to long-term effects of the sanctions from EU/Ukraine/Russian perspective

Europe is decoupling from Russia

Figure 3 below shows the share of Russian goods in the EU's imports (trade outside of the EU). The important thing to note is that over the years, the economic significance of EU-Russia trade was based on energy. All other (non-energy) trade with Russia was always a very small component, when measured either as a proportion of total EU trade with third countries or in terms of GDP. Figure 3 shows that energy trade has decreased significantly. Imports of coal collapsed immediately when sanctions were imposed, whereas imports of oil and gas have gradually declined.

Figure 3: Share of Russian energy goods in EU imports from non-EU countries (on the basis of import values)



Source: Bruegel based on Eurostat's 'EU trade since 1999 by SITC' dataset.

Note: the average shares of the four product categories in total EU imports from all countries of the world in 1999-2023 were: coal, coke and briquettes 0.8 %, gas 3.8 %, petroleum 15.9 %, and non-mineral fuels 79.4 %. Thus, the high share of Russia in the EU's coal imports in 2021 was overall a small share of total EU imports.

As shown in the previous section, the energy bill that the EU is expected to pay to Russia in the course of 2023 is much smaller than in earlier years. The EU is now looking to decouple completely from Russia by buying energy from other countries and by accelerating the green transition.

The Ukrainian economy and its reconstruction needs

Russia's war on Ukraine has had a devastating short-term effect on the Ukrainian economy. However, there is already an ongoing discussion on the reconstruction of Ukraine. The plans for reconstruction should not be based solely on damages, but rather on the vision of Ukraine in Europe in the coming decades.

Following Ukraine's successful liberation of parts of the country and better protection of Ukraine's airspace with the help of international partners, economic activity is gradually returning. The Kyiv School of Economics estimates that at the beginning of Russia's full-scale military aggression of Ukraine, almost 9 out of 10 enterprises were completely or largely shut down. A year on, the share of such enterprises is now fewer than 3 of 10. The share of companies reporting problems with utility outages, logistical problems and fuel shortages has also decreased (Kyiv School of Economics, 2023b).

The G7 has agreed to provide Ukraine with USD 39 billion^{lxviii}, and the IMF has recently approved a new program exceeding USD 15 billion. However, the reconstruction of Ukraine will likely require more than USD 150 billion, under the most conservative assumptions. According to the World Bank, the estimated cost of reconstructing Ukraine is at least EUR 500 billion^{lxix}. In June 2022, this was estimated at EUR 350 billion, but as the war continues this will also increase^{lxx}. It is telling that by comparison to Ukraine's GDP (USD 200 billion in 2021), reconstructing the country will cost multiple times that.

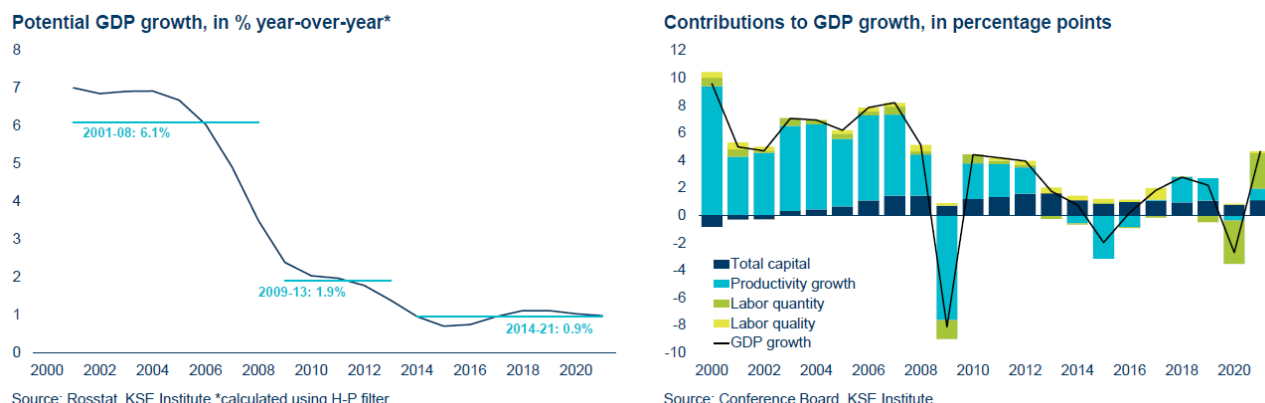
Reconstruction of housing and energy infrastructure, and the de-mining of agricultural land are the most important short-term priorities. Ukraine cannot wait for the end of the war to start reconstruction. In the medium-term, Ukrainian authorities need to develop a strategy on how Ukraine would fit in Europe in 15-20 years from now, rather than base the reconstruction strategy solely on damage assessment. It will be important for the government to maintain fiscal sustainability and rely on grant and concessionary financing. The private sector has already shown strong interest in reconstruction projects but will require security guarantees and war insurance.

Russia's long-term potential will be further compromised by sanctions

However, one should not focus excessively on short-term cyclical trends. Instead, what matters is the gloomy outlook for Russia's potential growth (Figure 4) (Prokopenko, 2022). Sanctions are having a particularly pernicious effect, given Russia's existing vulnerabilities, including under-investment, demographic challenges and low productivity (Dabrowski and Collin, 2019; Ribakova, 2023).

Russia's economy, according to Kyiv School of Economics (2023a), was not in good shape – even before the latest war – and had experienced a decline in potential growth, to around 1 % by 2022. Following a decade of rapid integration into global markets and increased commodity prices, growth failed to recover in the post-Global Financial Crisis years. After the 2014 sanctions, Russia's growth again halved, as Russian authorities pursued a strategy to reduce inter-dependencies with the West and build up buffers against external shocks.

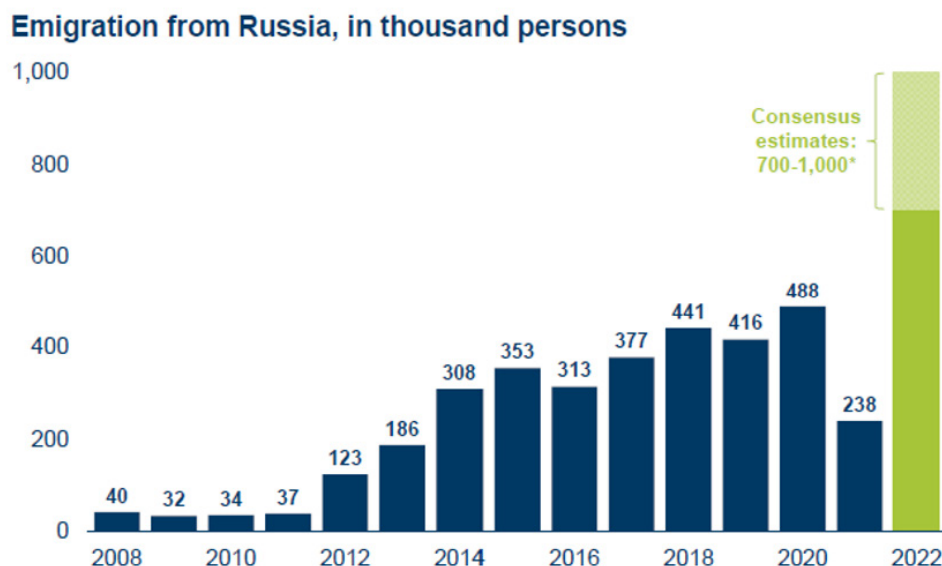
Figure 4: Russia, potential and actual growth: Potential growth (a) and contributors to actual growth (b)



Despite plans for diversification, areas that have seen positive investment dynamics since 2014 (Figure 4b) are the extractive industry, services, and – to a lesser extent – agriculture and chemical production (Belousov et al., 2023; Ribakova, 2023).

Plekhanov (2013) argues that the strategy that Russia pursued of implementing programmes to generate state champions led SOEs to dominate in every sector, which biased the economy and augmented dependence on energy exports. Similarly, COVID-19 highlighted Russia's most recent government-managed-reform failure in healthcare (Sokolov, 2020). While diversification, particularly of non-energy export-oriented industries, is necessary for the resilience of the economy, this is unlikely to happen following export controls, as argued by Karlova, Morozov & Puzanova (2023). Many companies have scaled down operations and will face pressure to leave altogether^{lxxi}, although at the moment only 6 % of foreign companies have left Russia and 37 % are in the process of leaving^{lxxii}. None of this will help an already-poor growth in productivity.

Even the Bank of Russia has expressed concern regarding the tightening labour market. Unemployment was down to 3.7 % by end-2022 (from 4.3 % at the end of 2022). Many Russians have left the country – nearly 1 million persons in 2022 alone (Figure 5, reproduced from the Figure on page 40 of Kyiv School of Economics, 2023a). Even before Russia's full-scale invasion of Ukraine, Russia's younger^{lxxiii} and higher educated were keen to look for opportunities abroad; with the war and mobilisation, the trend has accelerated (Strack et al., 2018).

Figure 5: Russia, emigration

Source: Rosstat, KSE Institute *publicly-available estimates from media reporting

The short-term stabilisation of Russia's growth is deceiving. While Russia prepared well and technocrats responded skilfully to the war and sanctions, Russia benefited primarily from outsized export proceeds that it could use to support the economy in 2022, as Europe needed time to move away from Russian energy. Still, despite the positive contribution from government spending and war-related production, Russia's economy still contracted by ~2 % last year.

Having lost the EU as its most important energy export market, Russia is looking for alternative export destinations. Darvas and Martins (2022) and Babina et al. (2023) show that Russia was able to redirect crude oil exports to countries including India, China, and Turkey, but this did not fully compensate for reduced exports to the EU. Moreover, the corresponding earnings were substantially lower due to higher transportation costs. At the same time, those segments that were not affected by EU sanctions, like exports from Russia's Pacific Ocean ports, did not generate lower revenues. Importantly those markets did not comply with the price cap.

Nevertheless, Russia will continue to slide back towards weak potential growth in the long run. But it is important to manage expectations regarding the impact of sanctions on a country that is, after all, the world's ninth-largest economy and a critical supplier of energy and other raw materials. Sanctions are particularly dangerous as they exacerbate pre-existing maladies such as chronic under-investment, labour shortages, and low productivity. Sanctions are already having an effect, but perseverance is a must, and tightening in response to leakages is critical.

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