

Alfons Weichenrieder

Russia Today – The Russian Invasion of Ukraine and Russia's Public Finances

SAFE Policy Letter No. 96 | March 2022

Leibniz Institute for Financial Research SAFE
Sustainable Architecture for Finance in Europe

policy_center@safe-frankfurt.de | www.safe-frankfurt.de

Russia Today – The Russian Invasion of Ukraine and Russia’s Public Finances*

*Alfons J. Weichenrieder, Goethe University Frankfurt, Leibniz Institute SAFE, Vienna University of Economics and Business, and CESifo**,¹*

March 2022

Abstract

This policy letter collects elementary economic statistics and provides a very basic look on Russian public finances (i) to inform the reader’s opinion on a possible planning process behind the war against Ukraine and (ii) to discuss prospects of an energy embargo and its capability to affect the stability of the Russian economy.

I. Introduction

For many observers in the western world, the invasion of Ukraine by Russia, which started on 24 February 2022, came as a surprise, despite earlier Russian aggressions and transgressions, as the annexation of the Crimea in 2014.

This policy letter is taking a look at Russian publicly available budget and expenditure figures and discusses to what extent these figures (in hindsight) suggest strategic preparations for a major war against Ukraine or other countries. At the time of writing, it is uncertain to which extent the territorial ambitions of Russia may be satisfied in the case of a possible Ukrainian defeat or, conversely, to which extent the ambush reflects a wider plan to expand the imperial range of Russia to the former USSR borders and even beyond. Observations on the development of public finances and reserves may provide signals as to whether the war on Ukraine was following deliberate planning and when such a planning may have started.

There are at least two hypotheses about the start of the concrete planning of military actions. One possibility is that the Ukrainian Maidan revolution, which started in November 2013 and ended the

* SAFE Policy Papers represent the authors’ personal opinions and do not necessarily reflect the views of the Leibniz Institute for Financial Research SAFE or its staff.

** Corresponding author: a.weichenrieder@em.uni-frankfurt.de.

¹ This Policy Letter is part of the SAFE research project “Public Finance and Fiscal Institutions in Europe”. Research assistance by Hirofumi Takikawa is gratefully acknowledged. I also received helpful comments from Patrick Blank and Hoang Ha Nguyen Thi. All errors are mine.

presidency of the Russia-friendly Viktor Yanukovich in February 2014, changed the Russian perspective on the use of its military forces in Europe. One piece of evidence in favor of this hypothesis is that, already in February 2014, hence in very close connection to the Maidan revolution in Ukraine, Russia occupied the Crimea and in March 2014 a referendum about accession to Russia was held.²

An alternative hypothesis is that Putin, since his raise to power in 2000, has always been looking for ways to overcome the “genuine tragedy” of the Soviet Union collapse and break up.³

The analysis of the Russian public finances is not only important to gain possible insights into possible financial preparations for international conflicts. It may also yield useful information as to what extent Russia may be vulnerable to western sanctions.⁴ The paper illustrates the effects of previous swings in resource rents to inform the estimate of how a western embargo might play out. It also makes the point that the mere nature of the resource extracting sector may make it more difficult to inflict a high price on a resource extracting country.

II. Central Bank Reserves

When it comes to indicators for Russian war preparations, some authors have pointed to the development of Russian gold reserves; see, e.g., Helman (2022). In the New York Times, Fisher (2022) interpreted the reserve hoarding as a part of a wider plan to make the Russian economy less vulnerable to western sanctions. Indeed, if the growth in gold reserve is taken as a signal for preparations, these preparations have been ongoing for a while. There had been an upward development of gold reserves starting in 2009. This development coincides with reports that, in 2009, Russia increased its gold production by 21%.⁵ Figure 1 is also conveying that in quantity terms (tons), the gold reserve accumulation accelerated in mid-2014, possibly as a reaction to the sanctions by western governments after the Crimea annexation. It levelled off in 2020.

The accumulation of reserves is less steady in Figure 2. Here, the blue line reports the combined values of foreign exchange, IMF special drawing rights, reserve positions in the IMF, and gold. The red curve reflects foreign exchange only, excluding gold and IMF assets. It becomes apparent that, while gold reserves have grown significantly, foreign exchange reserves have been increasing between 1999 and

² Mearsheimer (2022) argues that Putin, as early as 2008, vowed to split the Ukraine and grab the Crimea in case of a Ukrainian NATO accession.

³ Related remarks by Vladimir Putin abound (see, e.g., NBC, 2005).

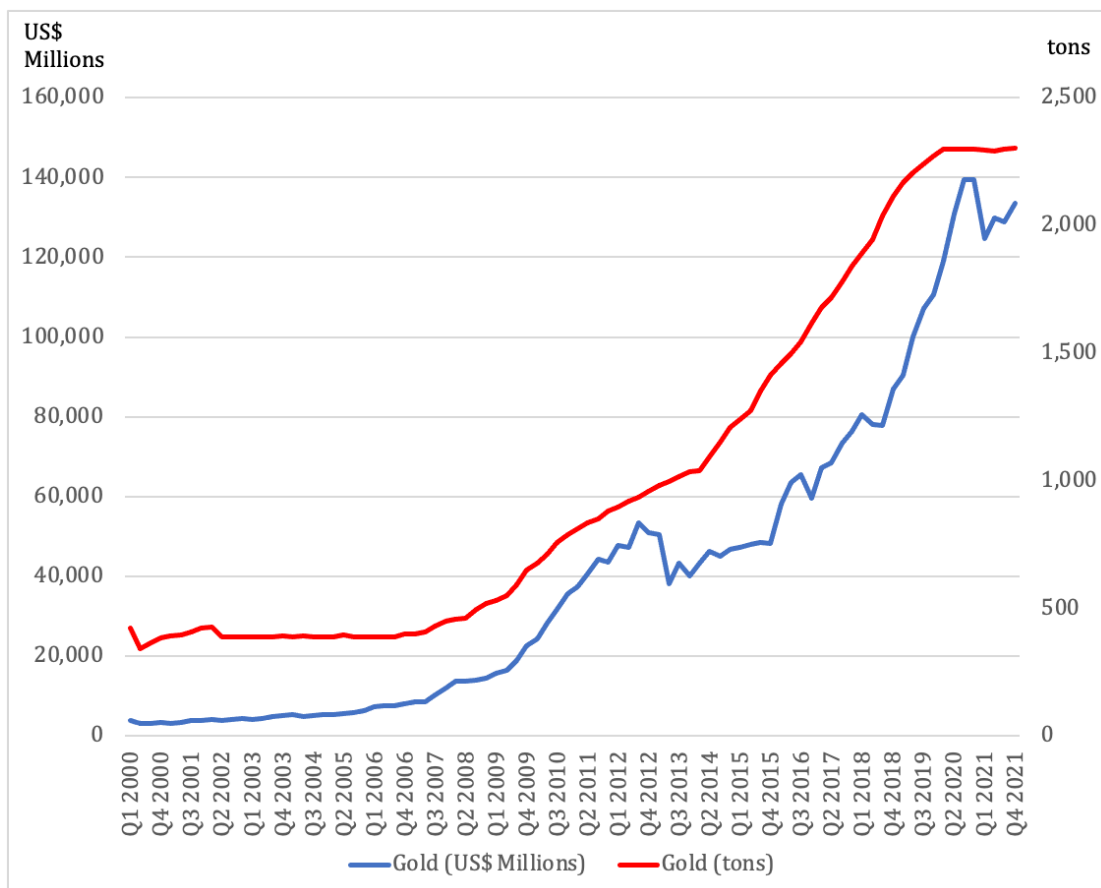
⁴ Historically, sanctions have a very dubious history for stopping an aggressor. For a literature review, see Hufbauer et al. (2007). In the past, sanctions have been helpful to target human rights violations, they seem to have been much less successful in stopping full-fledged military aggression.

⁵ <https://www.cnn.com/2011/07/18/The-Worlds-Biggest-Gold-Reserves.html> (accessed 21 March 2022).

2006. This development has been interpreted as a reaction to the experiences of the Russian financial crash of 1998.⁶ Foreign exchange reserves have been fluctuating around US\$400 bn. Since 2007 and, despite the attention that has been given to gold, still provide for the lion’s share of the central bank’s financial reserves. This said, the freezing of the Russian currency reserves by the EU and the US should increase the relative importance of gold.

Overall, there is a mixed picture. While the build-up of gold reserves, compared to the alternative of foreign exchange, in particular US\$, may increase independence, the process has been initiated well ahead of the Maidan revolution and the occupation of the Crimea, although some acceleration after 2013 is detectable. The initial timing suggests that the decision on the gold build-up is mainly based on experiences during the financial crisis.

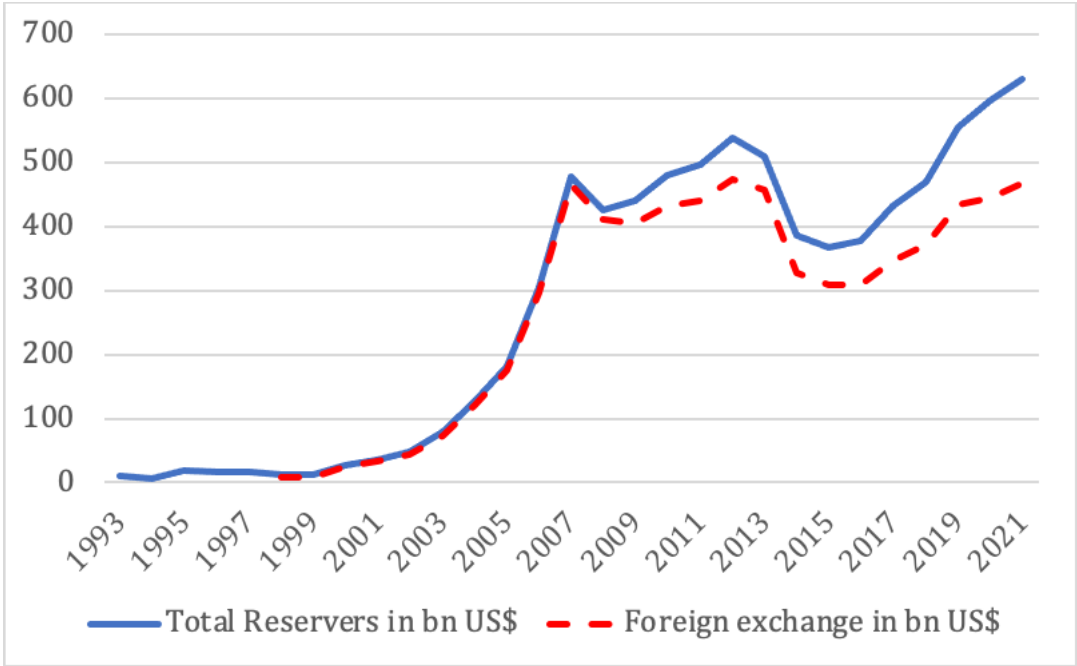
Figure 1: Development of Russian Gold Reserves



Note: The red line measures gold reserves in million US\$ and is plotted against the left-hand axis. Volume (in tons) is plotted in blue against the right y-axis. The graph is based on data from www.gold.org (accessed 21 March 2022).

⁶ For an interesting account by economic historian Adam Tooze, see New York Times (2022).

Figure 2: Total Foreign Reserves of Russian Central Bank (bn. US\$)



Note: The blue line represents foreign exchange reserves, gold, SDRs, IMF reserve position at the end of each period. The red dotted line excludes gold and IMF assets. Data is taken from World Bank, <https://data.worldbank.org> (accessed 21 March 2022), and the Bank of Russia (www.cbr.ru; accessed 21 March 2022).

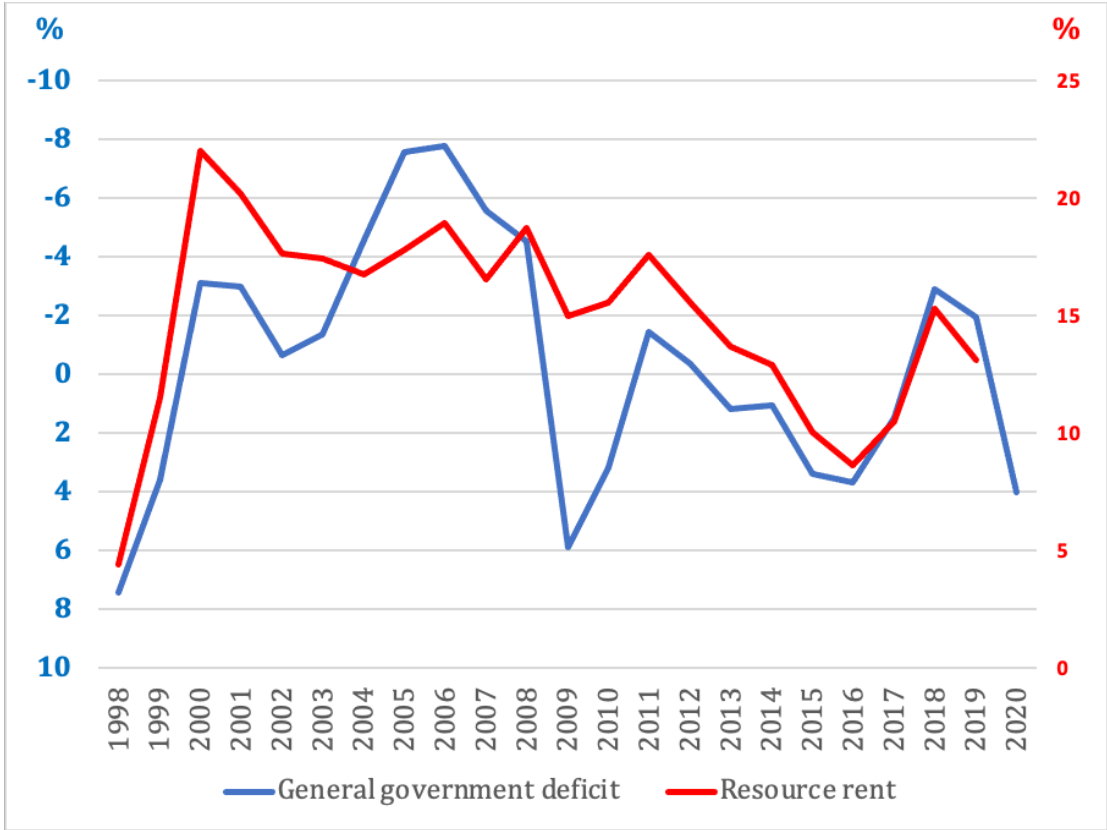
III. Public Finances

One possible way to isolate or protect oneself from sanctions are currency and gold reserves. A further instrument are healthy public budgets.

Figure 3 illustrates, that for quite some time, Russia achieved low general public deficits on average. With the exception of the years 2009 and 2010, which should reflect the fallout of the financial crisis, the government deficit (in blue) closely follows the rent from natural resources (in red).⁷ The deficit has been plotted against a downward pointing y-axis for better illustration of the co-movement, i.e., a higher point on the blue line indicates a higher deficit. Across 1998 to 2019, the correlation coefficient of public deficit in percent of GDP and natural resource rent in terms of GDP was -0.75 , despite a considerable divergence in 2009-10.

⁷ This resource rent has been taken from World Bank data and measures the revenue from the resources' market price but deducts the variable cost of intermediate inputs and normal profits. See World Bank (2021, p. 232).

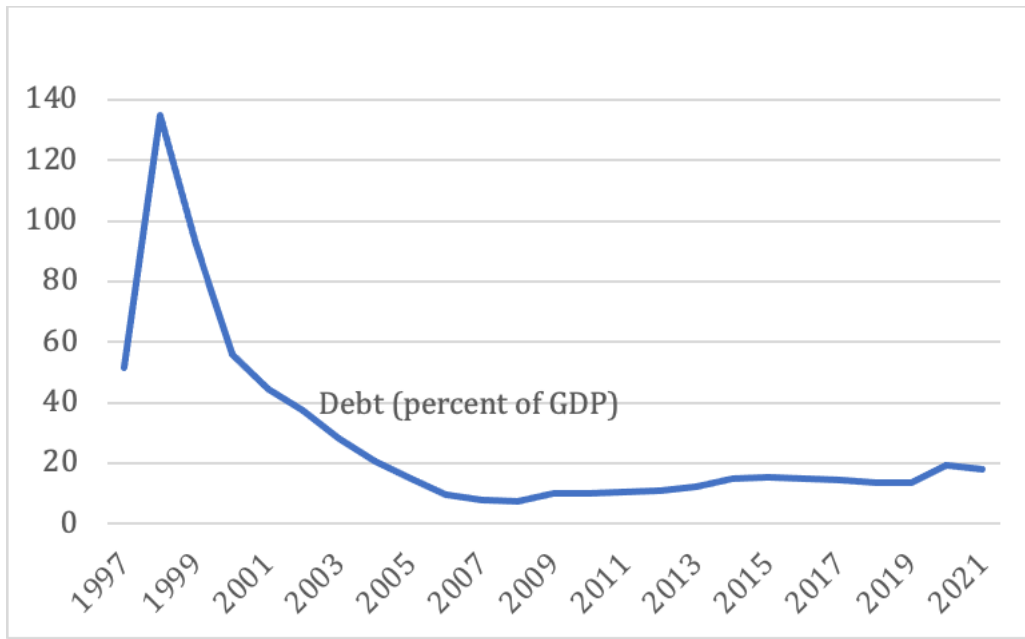
Figure 3: Public Finance and Resource Rents in Percent of GDP



Note: The blue line is plotted against the left axis and represents the general government deficit in percent of GDP as taken from the IMF, World Economic Outlook Database. Negative values indicate surpluses. The blue line is plotted against the right axis and reports resource rent in percent of GDP, as reported by World Bank, World Development Indicators. Note that, to illustrate the negative correlation between the two data series, deficits are reported in reverse order: higher values imply lower absolute deficits. In 2006, for example, the budget had a *surplus* of roughly eight percent of GDP.

Healthy surplus years were recorded before the financial crisis. The yearly average of deficits between 1998 and 2020 was only 0.44% of GDP. The years between 2010 and 2020 generated a somewhat higher deficit averaging 1%. Given these low deficits, the moderate upward trend in total debt to GDP, as illustrated in Figure 4, may come as a surprise, as the average nominal growth rate of GDP was some hefty 9% during this period: the higher nominal growth, the easier it tends to be to stabilizing the debt-to-GDP ratio.

Figure 4: General Public Debt (Gross) in Percent of GDP



Note: Data is from the IMF, World Economic Outlook Database.

To check for possible irregularities, consider some basic public debt accounting. In the absence of stock-flow-adjustments, the change in debt is governed by the simple accounting identity,

$$B_t = B_{t-1} + D_t \quad (1)$$

where B_t is the total stock of nominal debt at the end of year t and D_t is the nominal deficit in year t . Using z_t as the nominal growth rate and Y_t as nominal GDP, we can rewrite this equation using lower case letters that indicate variables scaled by GDP ($b_t = \frac{B_t}{Y_t}$; $d_t = \frac{D_t}{Y_t}$):

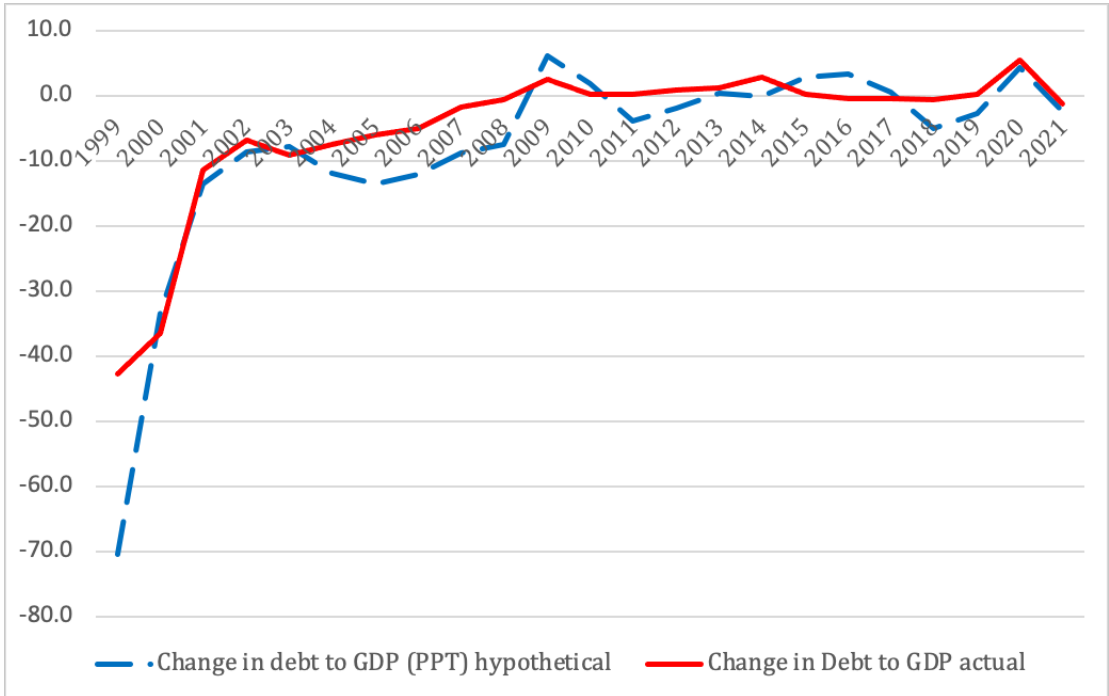
$$\Delta b_t = (1 + z_t)d_t - z_t b_t \quad (2)$$

In words, equation (2) says that the hypothetical percentage point change of the debt-to-GDP ratio, b_t , should equal the growth factor of GDP, $(1 + z_t)$, times the deficit ratio, d_t , minus the product of the nominal growth rate and the debt-to-GDP ratio. Δb_t is a hypothetical change in the absence of stock-flow adjustments.

Because of stock-flow adjustments, the actual change of debt-to-GDP can be lower or higher. Stock-flow-adjustments may be owed to debt denominated in foreign currencies. For example, if some debt is denominated in dollar and the dollar appreciates against the ruble, then this tends to increase the debt-to-GDP ratio even in the absence of a budget deficit. Stock-flow-adjustments may also occur if some expenditures are hidden in special entities, the debt of which is taken over by the central

government (possibly sporadically). For this reason, those adjustments could also reflect military expenses outside the official budget.

Figure 5: Stock-Flow Discrepancies



Note:

Data on actual deficits is from the IMF, World Economic Outlook Database. The blue line of hypothetical discrepancies in the absence of stock-flow adjustments is based on equation (2) and IMF data.

Figure 5 illustrates the difference between the actual deficit (in red) and the deficit, that is expected in the absence of stock-flow-adjustments, i.e., using equation (2) and the actual history of debt and GDP. For most years, the actual increase in debt is bigger than the hypothetical one and the red curve is above the blue. This said, larger discrepancies appear before the financial crises, smaller differences after 2011. For the last ten years, this does not suggest that military expenditures were hidden in stock-flow adjustments. The next section will in more detail look at reported military expenditures.

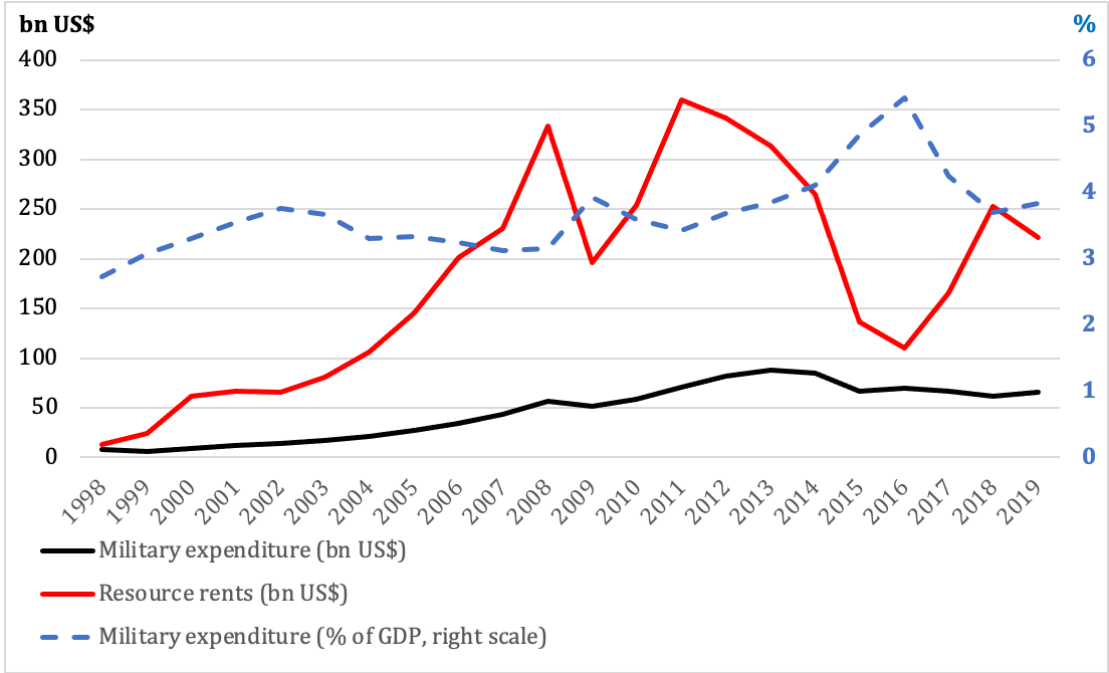
IV. Military Expenditures

In the current situation, a public expenditure of particular interest is military expenditure. Figure 6 illustrates the development of these expenditure in billions of US\$ (black line) and in percent of GDP (blue line). The blue line puts military expenditure into perspective by comparing it with Russian yearly resource rent (red line).

When looking at military expenditure as a fraction of GDP, a peak is visible around 2015. Yet, this should not be interpreted as a deliberate reaction to the Maidan revolution. Rather, the relative

increase is probably due to a mechanical effect as real GDP in 2015 shrank by some 2% in connection to the Russian financial crisis 2015-16 that was partly triggered by low oil prices and led to a huge depreciation of the ruble. Note that GDP, denominated in US\$, even contracted from 2.29 trillion in 2013 to 1.28 trillion in 2016, which amounts to a 44% reduction when measured in international currency. If measured in US\$, military expenditures peaked in 2013 and somewhat levelled off after the Maidan revolution.

Figure 6: Military Expenditure and Resource Rents in Comparison



Note: Data on military expenditure is from SIPRI, Stockholm. Resource rents are taken from the World Bank.

V. Possible Effects of Reduced Fossil Fuel Exports

An imminent question is to which extent a stop of fossil fuel purchases by the West can reduce Russia’s economic means to continue the war against the Ukraine.

From previous experience, as captured in Figure 6, we see a mixed picture when looking at the relationship between Russian military expenditure and the resource rents cashed in. During the years before the financial crises, we see a US\$ increase in military expenditure that, while almost constant in percent of GDP, may have been fueled by the explosion of natural resource income. After 2008, the large fluctuations in resource rents are not quite mirrored in military expenditures. As we saw in Section 3, lower resource rents, at least in the past, could largely be cushioned by taking out additional public debt.

When it comes to the budgetary implications of lower resource rents, we may also take a look at the past. Here, a one percentage point (ppt) reduction of the resource rent (relative to GDP) has led to an increase of the deficit ratio by 0.75 ppt. The last World Bank figure for Russian resource rents is somewhat outdated, but if we start from some 15% of GDP, sanctions could well wipe out that part that is owed to gas exports. Conversely, oil exports may be more easily redirected, although Russian oil is at the time of writing is traded at a US\$30 discount compared to non-Russian oil, even without a European embargo against Russian oil.⁸ In any case, based on previous experience, one may expect that any ppt reduction of resource rent in GDP may lead to a 0.75 ppt increase in the budget that requires financing through debt.

In the case of oil, in 2020 Germany bought 8.7% of Russian exports, Europe as a whole roughly half of these (Siedenbiedel, 2022). With 32.8% of exports going to China, the effects of an EU embargo can only be partial.

A different picture applies to natural gas exports. Here, in 2020, 24% went to Germany, and 54% to the rest of Europe, including Turkey.⁹

Reuters (2022) reports that, in 2021, Russian crude oil exports accounted for US\$110.2 billion, oil products for US\$68.7 billion, pipeline natural gas for US\$54.2 billion and liquefied natural gas was sold for US\$7.6 billion.

With lower capital exports and some arm twisting of domestic savers into Russian government bonds it seems realistic that Russia could fend off even a large drop in resource rents, say be 10 ppt, in particular since remaining sales may be possible at higher prices than in recent years.

A somewhat neglected aspect that highlights possible difficulties of sanctioning Russia by stopping energy imports is that sanctioning natural resource producers is different from sanctioning ordinary producers of goods and services. If the latter are sanctioned, lower production in the period of sanctioning cannot be easily made up for in later periods. For example, a service not exported means that some production factors are idle. Avoiding idleness of production factors in manufacturing required storing the output during the sanction period, which may collide with financial and spatial restrictions.

⁸ Based on a communication by Gabriel Felbermayer, Wifo, Vienna.

⁹ <https://www.iwkoeln.de/presse/iw-nachrichten/verkraftet-europa-einen-importstopp.html> (accessed 24 March 2022).

In the case of natural resources, storage is automatic. Any unit not extracted today is kept in the ground and is available for extraction in the future. This means that some part of oil and gas revenues may not be lost, but only pushed back in time.¹⁰

The importance of this effect is related to extraction costs. If extraction costs make up for the lion's share of the resource revenue, then during a sanctioning period a large quantity of production factors may lay idle and the economic losses are large. Conversely, if a huge share of revenues represents an economic rent, then the loss, seen from an intertemporal perspective, should be small.

For Russian oil, estimates of the extraction costs differ substantially. Saudi Aramco recently estimated Russian extraction cost to exceed US\$40 per barrel (Moscow Times, 2019), but this figure is highly contested. Marszalkowski (2020) puts the extraction and transport costs of Rosneft at somewhat over US\$15, which implies that a major part of sales is representing a resource rent.

VI. Conclusions

When it comes to the question of whether Putin's Russia has prepared the aggression well ahead, the evidence presented above is weak. Some authors have interpreted the high gold reserves as a preparation to withstand western sanctions. While impressive gold reserves indeed have been built up, the start of this policy seems more related to the financial crises than a reaction to the Ukrainian Maidan revolution in 2013/2014, although, thereafter, some acceleration did occur. There are little signs for Russian war preparation in other indicators presented, which may suggest that the decision to wage the war is relatively recent or, alternatively, that the intensity of the war may have been underestimated. An alternative hypothesis that cannot be completely dismissed is that the build-up of financial independence and military capacity may have been a longer plan, the start of which predates the changed situation in the Ukraine.

The evidence put together in this note also illustrates the limits of energy related sanctions. Russia has withstood huge swings in energy revenues in the past. From 2011 to 2016, the Russian natural resource rent as reported by the World Bank collapsed from US\$360 to US\$110 bn. This created a severe financial crisis which crushed the ruble exchange rate. At the same time, Russia could largely accommodate the reduced rent by higher budget deficits. The low debt-to-GDP ratio helped.

¹⁰ It could be argued that greening economies that react to climate change may reduce their demand for carbon fuels in the future. For that reason, Russian oil left in the ground could depreciate more quickly than without greening economies. This argument would overlook, however, that other oil exporters may react to slower Russian extraction by extracting faster, increasing future oil prices and making future Russian extractions more valuable.

A similar situation may evolve in the case of a severe embargo against Russian gas and oil. While there is a strong relationship between a possible cut in energy rents and public deficits, reduced capital exports and pressure on domestic savers may well create enough demand for public debt to fill the gap. Confidence in Russian bonds may not only benefit from growing nationalism and Russian propaganda. It may also rest on the fact that a reduction in energy exports today potentially allows for more energy exports in the future. Hence, to a considerably extent, sanctions in this area do not wipe out Russian wealth, but, to some extent, merely change the portfolio composition of that wealth. More of it stays in the ground, although perhaps only temporary.

Even if their leverage on Russia is limited, sanctions on oil and gas exports may be a more general signal, both as a commitment in future conflicts, as well as a signal of unity towards China, as recently suggested.¹¹ At the end, it is a political decision to expand sanctions.

¹¹ See Hufbauer and Hogan (2022).

References

- Helman, Christopher (2022), "How Can Putin Afford War in Ukraine? His \$130 Billion Gold Hoard Helps", *Forbes* Jan 31, 2022, <https://www.forbes.com/sites/christopherhelman/2022/01/31/how-can-putin-afford-war-in-ukraine-his-130-billion-gold-horde-helps/> (accessed 21 March 2022).
- Fisher, Max (2022), "Putin, Facing Sanction Threats, Has Been Saving for this Day", *New York Times*, 3 Feb 2022, <https://www.nytimes.com/2022/02/03/world/europe/putin-sanctions-proofing.html> (accessed 21 March 2022).
- Hufbauer, Gary Clyde and Megan Hogan (2022), *How Effective are Sanctions against Russia?* Peterson Institute, <https://www.piie.com/blogs/realtime-economic-issues-watch/how-effective-are-sanctions-against-russia> (accessed 24 March 2022).
- Hufbauer, Gary Clyde, Jeffrey J. Schott, Kimberley Ann Elliott and Barbara Oegg (2007), *Economic Sanctions Reconsidered*, 3rd edition, Peterson Institute, Washington D.C.
- Marzalkowski, Mariusz (2020), "How much does Russian oil really cost?", *Biznesalert*, 30 April 2020, biznesalert.com (accessed 24 March 2022).
- Moscow Times (2019), "Russian Oil Production among Most Expensive in World", 12 November 2019, <https://www.themoscowtimes.com/2019/11/12/russian-oil-production-most-expensive-world-saudi-aramco-ipo-a68132> (accessed 24 March 2022).
- Mearsheimer, John (2022), "John Mearsheimer on why the West is Principally Responsible for the Ukrainian Crisis", *Economist*, 19 March 2022.
- NBC (2005), "Putin: Soviet collapse a 'genuine tragedy'", <https://www.nbcnews.com/id/wbna7632057> (accessed 24 March 2022).
- New York Times (2022), "Transcript: Ezra Klein Interviews Adam Tooze", <https://www.nytimes.com/2022/03/01/podcasts/transcript-ezra-klein-interviews-adam-tooze.html> (accessed 25 March 2022).
- Reuters (2022), "Factbox: Russia's Oil and Gas Revenue Windfall", <https://www.reuters.com/markets/europe/russias-oil-gas-revenue-windfall-2022-01-21/>, 21 January 2022 (accessed 24 March 2022).
- Siedenbiedel, Christian (2022), "Die Schiffe fahren andersrum", *Frankfurter Allgemeine Zeitung*, 24 March 2022, p. 70.