Peterson Institute for International Economics

Economic statecraft and the Russia-Ukraine war

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[00:00:24.08] - Anjali V. Bhatt

Hi, and welcome to PIIE Insider Live. I'm Anjali Bhatt, Communications Manager and Research Fellow here at the Peterson Institute for International Economics. I often say that one of the best parts of my job is that I can just walk into the office of some of the world's top experts and just ask them anything, and then they answer. So with PI Insider Live, you're coming with me to ask those questions and get those answers. Today we're speaking with Alina Rybakova, Nonresident Senior Fellow here at PIIE and a Director of the International Affairs Program and Vice President for Foreign Policy at the Kyiv School of Economics. Two things before we begin. Yesterday was a big day for US trade policy. Our next Insider Live on April 17th will be with trade economist Chad Bone. So please hold your specific tariff questions until then. Quick housekeeping for our live audience. There will be time for questions at the end. Go ahead and submit those via the Q&A function. Okay. So, hi, Alena. Hi.

[00:01:19.17] - Elina Ribakova

Thank you for having me.

[00:01:20.22] - Anjali V. Bhatt

So let's start with the tariffs because that's, you know, what's on everyone's mind. What is the trading relationship between the US and Russia, as well as the relationship between— the trading relationship between US and Ukraine?

[00:01:34.02] - Elina Ribakova

Well, Russian relationship with the US is severely diminished, partially because of sanctions, but also historically, US and Russia never traded that much. There was a period because of the sanctions on Venezuela that some of the Russian oil came to US. Now the whole trade relationship is about $3.5 billion per year. Not much at all. Russia exports natural resources and imports some other components, oftentimes actually components including for its sometimes

military production. Sometimes some of the trade is indirect, but it is a limited relationship. However, we do have Dmitryev, who is, I call him the Russian let's-relieve-sanctions envoy, but his official position is not that. He's CEO of Russia Direct Investment, Foreign Direct Investment Fund, or rather Direct Investment Fund, sorry. But indeed, he's here in the US having official meetings. I think it is mostly about sanctions, relief of the sanctions. And it's particularly ironic because Russia has been saying that sanctions are not working, yet the first thing or request they have for the new administration to have sanctions relief.

[00:02:37.29] - Anjali V. Bhatt

Okay, so let's talk a little bit about those sanctions. What are the economic and financial sanctions that the Western countries imposed on Russia? Yeah. Yeah.

[00:02:50.08] - Elina Ribakova

So I think the most meaningful ones are still financial sector sanctions. Then we have export controls and this G7 oil price cap for which the previous US administration was a very strong advocate for. As we know, for the oil price cap, European Union did actually an embargo with some carve-outs. And then the US was really forceful about having a cap rather than preventing Russian oil flowing to the market.

[00:03:14.04] - Anjali V. Bhatt

So explain how the price cap works.

[00:03:16.03] - Elina Ribakova

So exactly, let's start with the price cap. In theory, Russia shouldn't get provision of services to be able to sell oil at the price above $60 per barrel. So Russia for the longest time relied a lot on the insurance and the shipping services, mostly European, but not only, of the G7 countries. So therefore, if you were shipping Russian oil that was above $60 per barrel, you were not allowed to do that, for example. So there are two issues with that. I think largely the price cap is not working, hasn't been working for more than a year and a half now for two reasons. One is enforcement of the original price cap was really lax. It was almost nonexistent. On top of that, Russia has also invested into shadow fleet. So now more than 70% of Russian oil goes with a shadow fleet, meaning outside the reach of the G7 price cap.

[00:04:06.26] - Anjali V. Bhatt

So are those ships not G7 ships?

[00:04:10.03] - Elina Ribakova

They're not G7 ships, and they also do not have coverage by G7 insurance.

[00:04:15.14] - Anjali V. Bhatt

Okay.

[00:04:15.28] - Elina Ribakova

Although most recently we've heard that Russia even managed to register an insurer somewhere in the G7, which is actually a fake company, and providing insurance documents. So yes, Russia is trying to circumvent that.

[00:04:27.20] - Anjali V. Bhatt

Okay, so the oil cap isn't really working, or price cap, I guess. What are the financial sanctions that are still on?

[00:04:36.07] - Elina Ribakova

The financial sector sanctions, I think, are still the most powerful tool the US has because it can have direct financial sanctions, and many Russian large banks, large or say specific purpose banks, whether it's agricultural or military, are under financial sector sanctions from the US. So they cannot have access to the US market. Most of the international banks will not touch them. And also many of the Russian banks are delisted, also removed from SWIFT. So the messaging also gets a bit more complicated. It's important that not all banks are. So you still have a lot of Russian banks that can openly, legally, fully trade with international world. So Russia can redirect some of the flows via those banks. Nonetheless, it's still challenging. What was even more important is the previous administration in December 2023 gave an executive order where if you were to circumvent other measures on Russia, for example, export controls, you would still be in trouble as a financial institution. So this is a very strong threat of secondary sanctions, on other banks. And I think this is where US has real power. And that's what we have seen alter a lot of Russia-China trade in 2024.

[00:05:46.08] - Anjali V. Bhatt

Is the secondary sanctions where, so the US would sanction, say, a Chinese bank for transacting with the Russian banks.

[00:05:55.14] - Elina Ribakova

Exactly, for facilitating evasion of export controls, for example. The threat itself was very meaningful. And for the first 6 months of 2024, we actually saw a reduction in trade after I think more than 20 almost 30% growth in 2023. One, somebody could say that, well, there is also natural stabilization in the trade relationship after it exploded post-2022. But I think also its meaningful share was this threat of secondary sanctions because you saw a lot of Russian research and also Chinese comments about that to that effect saying, look, how can we find ways of circumventing? Can we use a branch of Russian bank like VTB in China? So there's been a lot of conversation which suggests that indeed sanctions had a meaningful impact.

[00:06:40.21] - Anjali V. Bhatt

And so the secondary sanctions are also something that the Russians are looking to get lifted.

[00:06:45.05] - Elina Ribakova

Most likely, yes. If I were looking from the Russian side, you know, sanctions not working, probably the first sanctions I'd be insisting to have lifted is this threat of secondary sanctions. And here, US doesn't even have to do much. They can just signal that, look, we're gonna close a blind eye, you know, turn a blind eye to this activity. And then of course, I would gradually start pushing for more and more financial sanctions to be relieved. And we have seen this in the sort of so-called Black Sea deal, whatever that might have been, on the Russian side that they put in as preconditions removal of the sanctions on the Agricultural Bank and some other financial institutions. So they're trying to stick the foot in the door and make a wider gap with the US. I think the oil price cap is also unpleasant because they invested probably more than $11 billion potentially into the shadow fleet. They would like to get rid of it. There is indeed a gap, you know, and sometimes it's wider in terms of what Russia is selling for. But so I think that's probably something that they will look into.

[00:07:42.27]

And finally, export controls, because of the circumvention by China, I think Russia is somewhat less worried about that aspect.

[00:07:50.29] - Anjali V. Bhatt

Okay, so let's talk about China. I know you testified to a congressional committee recently about the Russia-China relationship. So China is buying oil from Russia, and we now know that they are helping them with the financial sanctions. Say more about that relationship.

[00:08:12.04] - Elina Ribakova

So let's even step back a second. Russia is a big country, China is a big country, they share a huge border. Historically, they should have had a much more close relationship, but historically, the relationship has always been complicated. And this is partially during the Soviet times, there was a very chance of a very confrontational relationship. There's also debate about chunks of the border that haven't been fully closed. And so I guess it's two important powers in the region. Russia has always been wary of being eaten up by China, sort of turning into a junior partner. And that's why up until recently, Russia's been very cautious. So some sort of trade with China is actually normal for Russia, you know, just thinking about the gravity model in economics, right? But what I think has changed dramatically after 2022 is exactly China's role in supporting indirectly, and sometimes maybe directly, Russia's aggression on Ukraine. China has been very careful formally not coming out in support of Russia's invasion. And if you look at the old China's peace plan, one of the, I think it's probably the first item is the sovereignty, respecting sovereignty of a country.

[00:09:15.14] - Anjali V. Bhatt

They're big on that.

[00:09:16.15] - Elina Ribakova

Exactly. So it's incredible that China's, and also in the recent debates, China's been very quiet, but China's been also very opportunistic with Russia. It exports a lot to Russia as well. So it is now the largest trade partner for Russia, sort of displaced the European Union. It used to be the European Union and now is China. China has stepped up purchases of Russian oil, but not that much. You know, if Russia used to count maybe about 15% of Chinese oil imports, now it's maybe 19%. So China is also very cautious not to be too dependent on Russia. It wants to have diversified inflow of energy resources, but at the same time, it's opportunistically selling a lot of, almost everything else to Russia. So Russia is a junior partner in this relationship.

[00:10:03.06] - Anjali V. Bhatt

So of the oil, you said the 19% of oil that China imports is from Russia. How much? What's the proportion of Russian oil that's going to China?

[00:10:16.23] - Elina Ribakova

Well, it's probably China and India now account for the majority of the exports of Russian oil.

[00:10:22.05] - Anjali V. Bhatt

So it's like a really big deal.

[00:10:24.00] - Elina Ribakova

It is a really big deal. So after the embargo by European Union was with some sort of exceptions, Russia had to fully redirect its oil supplies. And it has gotten very costly. So that's why I think the embargo had the most important impact on Russian costs or sort of lower revenues. Because if you think about it, a lot of resources of oil or energy are in the sort of European, still closer to the European part. And a lot of infrastructure also happens to be towards Europe. The old pipeline, Druzhba, friendship, I think it's from the '60s, it is to Europe, right? So there is a historical geographical relationship there. So redirecting oil was costly. So they still have to get on the ships in Europe, go all around Europe, and then go to India or China. There is, on gas, it is much more complicated. There is a pipeline that goes for China for gas, but you cannot really put gas apart from LNG on the ships, right? So I think for gas, Russia hasn't been as successful in redirecting. And that's why it's also so desperate to try to come back to, European market for gas.

[00:11:30.14] - Anjali V. Bhatt

So are the Europeans buying gas from Russia?

[00:11:33.11] - Elina Ribakova

There are still residual purchases in Europe of Russian gas, but largely it has been cut off. Germany has cut off, you know, Poland. There are many countries that have fully cut off purchases of Russian gas. But now, of course, there are still some residual. And there is also a discussion, which is somewhat puzzling to me, of the US trying to help Russia export gas to Europe.

[00:11:59.14] - Anjali V. Bhatt

Why?

[00:12:00.06] - Elina Ribakova

That is an exceptionally good question. It's hard to understand from the macroeconomic perspective why, because also, US is one of the largest, if not the largest producers of gas

nowadays globally. It can also export. Their cost is a little bit higher than Russia's for Europe. We know that Germany very quickly reacted to Russia's invasion of Ukraine, built LNG terminals, so there are a lot of imports. Russia continued, by the way, to sell LNG to Europe as well. So Europe has diversified supply of gas. It's not just the US, it's also Russia and other countries. So Russia and US here are in direct competition for the market, whether it's in Europe or in Asia. So therefore, it's a little bit surprising that they would be advocating for their competitor to do better.

[00:12:52.20] - Anjali V. Bhatt

Okay. So what— the EU still is buying some gas from Russia. But, you know, we've seen that the EU-US relationship and the US-Russia relationship has changed. How is the EU dealing with this changing relationship? And what more do you think they can or should do?

[00:13:17.07] - Elina Ribakova

Well, I think Europe is definitely waking up. So in a way, there is sort of make Europe great again moment. The question is whether Europe will indeed take advantage of this opportunity. And I think for European politicians, it's important to understand that it's now, it's really truly all coming together. There's been this moment in the past, say, 10 years when Europe became a bit more geopolitical, right? The Commission became geopolitical, European Union, ECB started talking about promoting the role of euro. So we started going away from this old model in Europe where economics, WTO, international trade relationship are one thing and then security is another. So, but now the moment has come where they all unfortunately have to come together. We've seen important changes in Germany and we have seen fantastic presentation, I think the other day by our colleagues from Kiel Institute. I definitely strongly recommend to watch that.

[00:14:08.17] - Anjali V. Bhatt

Yeah, it was really good.

[00:14:09.08] - Elina Ribakova

It was fantastic. So I think it is a moment of truth for Germany. And so One needs to spend more on defense dramatically. One needs to have domestic production and diversification of basically supply for defense. And we have seen it, you know, that we're sort of going to US and buying in the US by itself is not enough. You know, you have to have your independence. Capital markets union, and again, Nicolas Varone and others have been writing a lot about it. I think it needs to come because of the funding needs and also the fact that the role of dollar is

being effectively undermined or sort of put into doubt. And I think that gives an opportunity opportunity to Europe. And then finally, preparing for potential, or sort of deterring Russia from moving further. And of course, the most expensive way of doing that would be allowing Russia to invade Ukraine fully and then having to deal with that situation potentially threatening Europe.

[00:15:04.05] - Anjali V. Bhatt

Okay, we don't want that. Okay, we're jumping around a little bit here, but that's fine. You've said in the past that Russia's economy is a wartime economy. What does that mean? And how have the sanctions that are still on, how has that affected this wartime economy?

[00:15:24.10] - Elina Ribakova

Well, Russia has moved towards militarization shortly after sort of 2022 invasion of Ukraine. Of course, the original plan for Russia was that it will be a couple of days affair. They will manage to conquer the whole of the 40 million country, and then somehow they will find support domestically, which was clearly a misinformed sort of plan. 3 years on, Ukraine Ukraine is still there, Ukraine is still holding back Russian troops, which I think it also gives a very strong signal about the quality and the ability of the Russian military that shouldn't be overestimated. So once they realized that it's not a quick affair, they started to become, they understood that they need to do mobilization. And that's what we saw in September 2022. And they also need to dramatically increase production because otherwise they just don't have enough equipment, they don't have enough sort of missiles, they don't have enough sort of military equipment to go forward. And that's when the militarization happened. So we have seen massive expansion of the budget spending, and this is federal budget, regional budget, and quasi-fiscal support or subsidized lending that went to the military-industrial complex. And recently we published a big report on military-industrial complex from the Kyiv School of Economics, and we're doing more work here on it as well at Peterson.

[00:16:40.17]

So Russia is doing a massive fiscal stimulus, and it's not clear it's actually getting that much for it. But nonetheless, you know, so 2022, '23, and the '24, we've seen the sectors that expanded are the ones related to the military only. However, with unemployment about over 2% in Russia and lack of investment still, Russia is beginning to hit supply side constraints. And that's why we have seen massive pickup in inflation last year. And that's why the policy rate at the moment is 21%.

[00:17:12.14] - Anjali V. Bhatt

So they're just pouring a bunch of money into basically just the military-industrial complex and they're not getting a ton out of it, or is the only benefit for the military and the fiscal push isn't benefiting anything else?

[00:17:30.02] - Elina Ribakova

It is, it's not getting, it's most likely it's not getting enough out of it. And that's why we see relationship with North Korea trying to get, you know, components from there or also people from there. So indeed the size of the fiscal stimulus is not allowing to get everything that they want. They want. And at the same time, they're also hitting the supply side constraint. There are just not enough people, not enough productivity growth, not enough capital stock to be able to produce as much as they need. And that's why if you look at the situation in Ukraine, even at the times when there was a pause in US support, and of course that is very important for Ukraine, but nonetheless, we still have seen Russia move forward only slowly.

[00:18:07.29] - Anjali V. Bhatt

Okay. There's so much there. We've spoken before. You said the regional spending has gone up and I don't, was it you or someone else presented about the regional effects of the war in Russia? So say more about that.

[00:18:23.19] - Elina Ribakova

Indeed, so it was Bank of Finland, BofA, and Yuriy Gornichenko and Inka Kakonen were working on a paper on the regional aspects of Russian economy. And indeed you see a very clear impact of sanctions and all the war on the geography of Russia. So the regions that used to export the most are the hardest hit and they haven't recovered. The regions that have focused on the military-industrial complex, that's where we see the boom, and particularly in wages. We've seen also the sort of income pickup in profits, but that has tapered off now. So we don't see as much of the profitability of the military-industrial complex, but we still see this massive wage increase for able sort of— it's not always about skilled labor, it's just physically about labor because many of these factories are working 3 shifts at the moment. And then you also have regions where people from the poor regions are volunteering for the contracts to go and kill in Ukraine or to go into the Russian army. And also the mobilization came from these poorer regions. So in this morbid way, it gives to some people who've never seen a social lift some sort of an opportunity at the moment.

[00:19:32.21] - Anjali V. Bhatt

Yeah, that is morbid. Let's talk a little bit about Ukraine's economy. Can we also describe that as a wartime economy? What is that picture like?

[00:19:44.19] - Elina Ribakova

Well, for Ukraine, we have seen a massive also transformation on the economy, but it's much harder to disentangle what is the civilian economy, what is exactly a war economy. So there's been great innovation in defense sector, but also other aspects of the economy continue to function. And I think there must be huge credit to the Central Bank of Ukraine, National Bank of Ukraine, because they managed to preserve financial stability. Stability through this very challenging times. And I think a lot of the reforms that happened after 2014 are the basis or the reason why the central bank is holding up so well. So inflation is not particularly high. We've seen some growth in Ukraine. People forget that, you know, we always focus on, oh, but Russia had growth of 2%, 3%, 4%. Ukraine also had growth of about 3% in recent years. So this is—we've seen a lot of stabilization. The economy functions, financial sector functions. I think on Ukraine's side, the big issue is that in terms of financial spending on the war, Russia has more resources because it's oil and gas, another commodities exporter. What Russia exports is 85% is natural resources, right?

[00:20:47.25]

So this classical thinking about guns versus butter needs to be adjusted for the fact that Russia has resources coming from the ground and we still want to buy them. So I think the policy choices for them are not that stark. For Ukraine, the military expenditure almost increased twofold. You know, it is a huge share of, as a percentage of GDP, and that's why they need international support to be able to continue because they have one budget that goes as usual on all the regular things that the budget needs, and then the budget almost the same size that goes to the war.

[00:21:18.21] - Anjali V. Bhatt

Well, yeah, that's a lot of money. So international support, I know that the US-Ukraine relationship has had its ups and downs. But one of the things that is being thrown around as part of that relationship is a critical minerals deal. What's the deal with that?

[00:21:41.07] - Elina Ribakova

So Ukraine does have critical minerals. There is lithium, there is many other items that are there. You know, there are the old surveys of where this—

[00:21:51.21] - Anjali V. Bhatt

They're like Soviet-era surveys.

[00:21:53.07] - Elina Ribakova

They're still, yeah, some of them older than others indeed. You know, that's pinpoint where exactly these critical minerals are. I think the issue here is to find a basis for a constructive relationship with the US. So this is Ukrainian authorities coming out and saying, look, you might have certain interests in Ukraine. How can we make it work for both of us? You know, we want to maybe be pragmatic. We understand that it's America first for this administration. Let's find us a constructive way to interact. Because for Ukraine, it cannot have a confrontational stance with the US. It doesn't make any sense, right? It's too small. It's busy protecting its sovereignty. And it has a very good constructive relationship with European Union. So Ukrainian authorities are not in a way of picking fights with anybody, particularly not with the US, right? So I think this is where the critical minerals deal comes in. Can we find a way to interest US companies to come to Ukraine, work together, and at the same time, because of this business-to-business engagement, provide sort of security to Ukraine more broadly?

[00:22:56.24] - Anjali V. Bhatt

Okay, well, we are almost at time. Wow, time flies, huh? I guess let's just wrapping up here. What will you be watching for in the next few months here with Ukraine, Russia, the US, the EU, you know, whatever?

[00:23:14.29] - Elina Ribakova

Well, I think for me, the first one is any discussion about sanctions relief with Russia. Because what we have seen so far was this deals recently, you know, it looks like the deals are disproportionately benefiting Russia.

[00:23:26.11] - Anjali V. Bhatt

So that's the Black Sea shipping deal and the targeting energy deals.

[00:23:31.07] - Elina Ribakova

Absolutely. Although none of them are fully quite closed. It's not clear where exactly they are, at what stage they are. But if you look at exactly the ceasefire on the energy front, it benefits Russia more because Russia has struggled with Ukraine hitting energy infrastructure or sort of refineries in Russia. While Russia hasn't been as successful as it wanted to completely destroy

energy infrastructure in Ukraine, and that's what they've been trying all of last year. So the ceasefire helps Russia recover a bit. If you look at the Black Sea, the same. If de facto, Russia doesn't have any control anymore of the Black Sea because of the, you know, of the situation on the ground, so Russia now through this deal is trying to get back in to have a say in what's happening in the Black Sea. So to me, these are signals that somehow some of the discussions are a bit more favorable to Russia than not. And that's why to sort of confirm or deny this hypothesis, I want to see what's happening with sanctions. And we have seen on the individual front some of the sanctions from Russian individuals being lifted recently.

[00:24:29.22]

That could be a signal of that. Let's see. So I'll be, first and foremost, I'll be watching that. The second one is indeed the minerals deal or any sort of deal. The ongoing discussion between Ukraine and US is already, to me, constructive. It's going to be difficult. You know, there will be some strong demands, you know, especially from the US. But the fact that there is an ongoing conversation to me is already helpful. And then the final one, to what extent Europe will stand up to the challenge and will become great again?

[00:24:58.00] - Anjali V. Bhatt

Well, that will certainly be interesting to watch. Okay, Elina, thank you so much for joining us. We covered a lot of ground there. So thank you all also for joining us for this edition of PIIE Insider Live. What did you think? What did you want to see? Um, let us know at meetings@piie.com. And if you're not already, uh, subscribe to PIIE Insider, the newsletter, at piie.com/subscribe. Our next episode will be on April 17th with Chad Bown on trade. Uh, thanks for joining and we'll see you then.