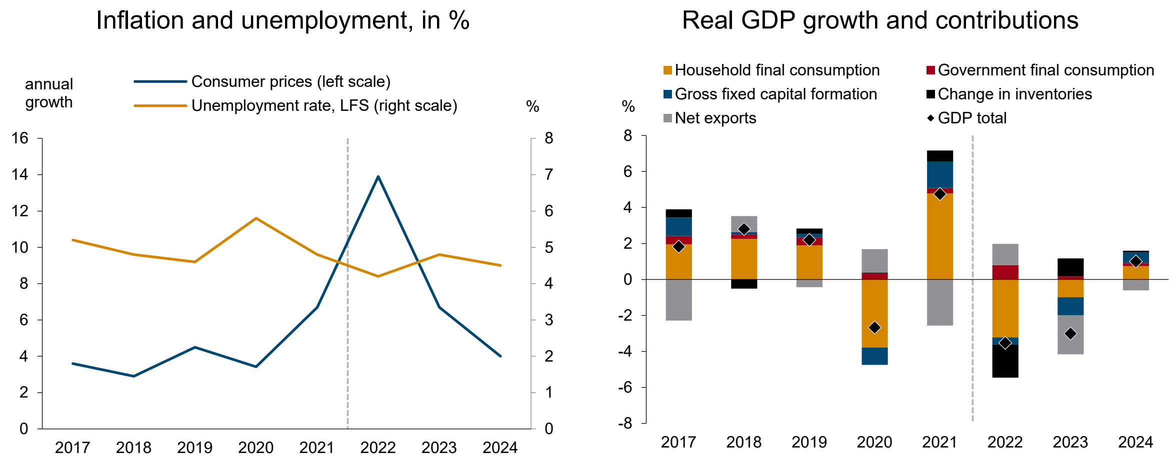
RUSSIA: The crisis in instalments

VASILY ASTROV

So far, the effects of Western sanctions on the economy have been generally milder than expected. By Q3 2022, the economy had partly adjusted to the 'new normal', thanks to high energy prices, trade reorientation towards Asia and increased military spending. However, with the newly announced partial mobilisation, another wave of the crisis looks to be on the cards. After an estimated decline of 3.5% in 2022, the economy is heading for another recession next year.

Figure 6.18 / Russia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The impact of Western sanctions on the Russian economy has been clearly felt, even if less than generally expected. It has become increasingly difficult to gain a comprehensive picture of the state of the Russian economy, since many statistical data have become patchy or are no longer published at all (including on foreign trade, foreign reserves, external debt, the energy sector and the government budget). Still, official statistics and anecdotal evidence suggest that the economy **has** been badly affected by Western sanctions, albeit less than expected. After still solid growth of 3.5% (year on year) in Q1, the economy slid into recession in Q2, with real GDP declining by 4.1%. The main drivers of recession were the downturn in private consumption (-5.5%) and the depletion of inventories. Public consumption was nearly flat (-0.4%), while net exports of goods and services contributed positively to growth (an estimated 1.7 percentage points (pp)), as imports suffered much more than exports. Gross capital formation plummeted by 13.8%, but gross fixed capital formation recorded an increase of 3.2%, partly on account of subsidized mortgage lending.

Industries directly exposed to Western sanctions have been hit the worst. In general, the worst affected were two types of industries: (i) export-oriented industries, which were directly affected by the Western sanctions, such as steel and timber;[21] and (ii) industries serving predominantly the domestic market that were largely foreign-owned and/or heavily dependent on imported parts and components, such as the automotive industry and factories producing household appliances. Other industries held up much better, and some reported increases in production. A similar diversity could be observed in services: half of the GDP decline in Q2 was on account of a single sector – wholesale and retail trade (-14%) – whereas construction, finance and public administration all reported solid growth.

Private consumption has suffered primarily on account of declining real wages and incomes, while the labour market has been generally resilient. Sharply rising inflation in the first few weeks of the war and sanctions meant that the annual dynamics of real wages turned negative from April – despite nominal wages continuing to rise by 10% or more. The high growth in nominal wages is partly to do with the general resilience of the labour market: unemployment (according to the Labour Force Survey) has remained at historically low levels of around 4% or below. However, the real picture is certainly not as rosy as the headline unemployment rate would suggest: 'hidden unemployment' is widespread, with firms typically cutting wages and salaries, pushing employees to take unpaid leave, and firing those over the age of retirement – rather than resorting to outright layoffs. Also, the very low level of unemployment benefits provides a strong incentive to take any job, rather than stay unemployed.

After initial sharp tightening, monetary policy has been markedly relaxed, in response to declining inflation. After an initial spike in March (of 7.6% against February), inflation was tamed very rapidly, and since May consumer prices have been essentially stable. Apart from the usual seasonal factors (falling price of food), price stability has been supported by the strong recovery of the rouble, which is now trading at above pre-war levels. In annual terms, inflation declined from 17.7% in April to 13.7% in September, allowing a marked relaxation of monetary policy. Since February, the policy rate has been cut six consecutive times, by a combined 12.5 pp. Standing at 7.5% at the time of writing, it is 2 pp below the pre-war level and – unlike before the war – is deep into negative territory in real terms.

Imports have been recovering on the back of the legalisation of 'parallel' imports and trade reorientation towards Asia. Trade sanctions, the departure of many Western companies and disruptions to cross-border payments led to a 23% decline in imports of goods and services in Q2 (year on year). 'Mirror statistics' from the country's main trading partners suggest that the bottom was probably reached in April, when merchandise imports plunged by half and imports from the West by two thirds or more. In response, the government drew up a list of 92 product categories that were eligible for 'parallel' imports, and this has helped with the partial revival of imports in subsequent months.[22] Nevertheless, as of July, imports were still an estimated 17% below the level of last year. Another factor that has facilitated recovery has been the trade reorientation towards Asia. Merchandise imports from China picked up by an estimated 22% year on year in July and by 26% in August, while those from Turkey – an important transit route for parallel imports – rose by 75% and 87%, respectively, in those two months. However, import recovery has so far been confined largely to consumer goods. Imports of investment goods in July were still an estimated 44% below last year's level – and from the EU, the fall was around 70%.

21 Production of fertilisers suffered on account of Russia's own export restrictions.

22 Parallel imports do not need to be authorised by producers and/or distributors, but they are not illegal per se.

Exports and the current account surplus surged on the back of high energy prices and the resilience of oil production in the face of sanctions. Since the start of the Ukraine war, oil prices have stayed at a fairly high level (though declining since mid-June), while oil production posted 3% growth in the first eight months of the year. In particular, Asian countries have been taking advantage of the price discount on Russian oil (although at the time of writing, the discount has narrowed to USD 15-20 per barrel, from some USD 30 in spring). In July, Russian total merchandise exports to India soared sixfold year on year; to Malaysia – by 2.5 times; to Turkey – by 78%; and to China – by 47%. Energy accounted for a large part of these increases. By contrast, gas exports dropped markedly in Q3, as supplies via the Nord Stream 1 pipeline were increasingly squeezed by Russia and were stopped altogether on 31 August (well before the explosions). Certain other export items (such as coal and metals) continued to suffer on account of Western sanctions. Overall, exports of goods and services increased by 27% year on year in Q2, so that the current account surplus tripled in January-August and will likely approach 13% of GDP for the whole year.

Many foreign companies have left Russia, which has contributed to its increasing economic isolation. By early September, of the 600 biggest foreign companies active in Russia, 34% had curtailed their operations, 15% had sold their assets and 7% had left their assets behind without selling them.[23] This trend reflects a multitude of factors, including concern among the companies for their public image, the sanctions, and logistical and payment disruptions. Anecdotal evidence suggests that the fear of potential nationalisation by Russia in response to the freezing of Russian assets in the West has also played a role. However, leaving Russia is not an easy task these days: selling Russian assets typically comes with a 70% discount,[24] while the withdrawal of Western investors from 'strategic' sectors, including energy and banking, was forbidden altogether by a presidential decree in August. The mass exodus of foreign firms contributed to a disastrous foreign direct investment (FDI) performance in the first half of the year, with FDI divestments of over USD 30bn, mirrored by a similar magnitude of divestments of Russian FDI abroad.

With rising expenditure on war, the days of fiscal surpluses are over. In the first eight months of 2022, federal government revenues picked up by 12.2% in nominal terms, while expenditure was up 19.5% – mainly on account of a sixfold rise in 'other expenditure', probably military related. With the economic recession deepening, the gap between revenue and expenditure will widen in the coming months, resulting in a likely budget deficit of 3% of GDP for the full year. Despite elevated expenditure and falling revenue, the federal budget for 2023 envisages a deficit of only 2% of GDP, which is to be attained thanks to increased taxation, particularly of the energy sector. However, the budget was prepared before the announcement of partial mobilisation and the annexation of the occupied Ukrainian territories of Donetsk, Luhansk, Kherson and Zaporizhzhia, and now appears quite unrealistic. Its financing will also become more challenging: while this year, the budget deficit should be covered by the National Welfare Fund (which stands at 8.9% of GDP), next year its financing will rely partly on domestic borrowing, which will become more expensive in the face of the heightened uncertainty.

By Q3, the economy had partly adjusted to the 'new normal', not least on the back of increased military spending. According to the estimates of the Ministry of Economic Development, the decline in GDP on an annual basis has been steadily moderating: from 5% in June to 4.3% in July and 4.1% in August, resulting in a recession of 1.5% in the first eight months. High-frequency data suggest that the

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23 Companies with at least RUB 5.7bn market turnover in Russia, https://www.rbc.ru/economics/07/10/2022/633e94809a79475aa5d84f00

24 Ibid.

dynamics of retail trade turnover became less negative, with an annual decline of 8.7% in July and 8.8% in August (compared to around 10% in Q2). Falling inflation contributed to a smaller decline in real wages, while credit expansion picked up markedly in response to monetary policy easing.[25] A good harvest contributed to a strong growth in agricultural production (+8.8% year on year in August), while the decline in industrial output almost came to a halt in August (-0.1%), thanks to the rising production of pharmaceuticals (+14.3%), 'fabricated metal products' (which includes weapons) (+16%), 'other machinery and equipment' (+9.1%) and metals (+4.1%). It is almost certain that at least some of these industries have benefited from increased military spending, which possibly hints at the forthcoming structural transformation of the economy towards the defence sector.

However, following the announcement of partial mobilisation, the economy is heading for another wave of crisis. The partial mobilisation announced on 21 September in response to a series of military defeats in Ukraine will likely deepen the economic recession in Q4 and remove some 0.5 pp of GDP growth for the full year. While the currently planned mobilisation of 300,000 people may not sound dramatic, the figure may end up being much higher – and could potentially affect 1.2m people. In addition, an estimated 500,000-700,000 reportedly left the country in the two weeks following the announcement, while many more have probably changed their residence within Russia. All this may have severe repercussions for the labour supply, with some of the most active and productive sections of the labour force being 'lost'. Consumer and investor sentiment is likely to suffer as well, and part of household income will probably be diverted, in order to bribe military officials. Besides, the tightening of cross-border restrictions by both Russia and the EU does not bode well for parallel imports, which may fuel inflation. Public consumption, associated with the deployment of the newly drafted army, will inevitably go up, but this will probably not be enough to offset the weakening in private demand.

Still, on the back of a surprisingly good economic performance in the first three quarters, the growth forecast for 2022 as a whole has been improved to -3.5% (from -7% in summer). Next year, the recession will almost certainly continue and will probably reach a similar magnitude as this year, as the effects of the Western trade sanctions increasingly come to be felt and as the EU oil embargo takes effect (in December 2022 on crude oil and in February on oil products). In response to the recent annexations, on 6 October the EU announced its eighth package of sanctions against Russia, which reportedly includes a price cap on Russian oil. Even though such a cap may be very difficult to implement in practical terms, it is likely that the discount on Russian oil on other markets will again widen. At the same time, Russia's own strategy of restricting gas supplies to Europe will weigh on its gas production and exports, given the near impossibility of diversification, on account of infrastructure bottlenecks.

Barring any major political change, the economy is poised for long-term stagnation. The main reason for this will be reduced access to Western imports and technology, with imports from third countries providing only partial relief. China does not produce the most sophisticated high-tech inputs that are needed for many sectors of the Russian economy (including the defence sector), while parallel imports are logistically challenging and inherently unstable. The potential for import substitution is limited as well, given the vastly different specialisation of domestic producers, who are unlikely to be able to take advantage of the new opportunities (with some niche exceptions). Having said that, the mobilisation announced may be a game-changer, undermining the hitherto solid popular support for President Putin and potentially triggering an overthrow of the political regime. But that would probably require sections of the ruling elite to switch sides, and at the time of writing it is unclear whether the cracks within the ruling elite are deep enough for such a scenario to materialise.

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[25] Still, on an annual basis the dynamics of credit for the non-financial private sector remains negative in real terms.

Table 6.18 / Russia: Selected economic indicators

	2019	2020	2021 1)	2021 January-June	2022 January-June	2022 Forecast	2023 Forecast	2024 Forecast
Population, th pers., average	146,765	146,460	145,864	146,017	145,648	145,000	144,800	144,700
Gross domestic product, RUB bn, nom.	109,608	107,390	131,015	58,006	69,293	147,900	150,600	158,900
annual change in % (real)	2.2	-2.7	4.7	5.1	-0.5	-3.5	-3.0	1.0
GDP/capita (EUR at PPP)	20,450	20,000	21,930	.	.	.	.	.
Consumption of households, RUB bn, nom.	56,110	54,046	64,805	30,105	33,891	.	.	.
annual change in % (real)	3.8	-7.4	9.5	11.0	-0.6	-6.5	-2.0	1.5
Gross fixed capital form., RUB bn, nom.	22,911	23,073	25,969	9,259	11,263	.	.	.
annual change in % (real)	1.0	-4.6	6.8	7.5	6.5	-2.0	-5.0	3.0
Gross industrial production 2)								
annual change in % (real)	3.4	-2.1	6.4	5.2	1.3	0.0	2.0	2.5
Gross agricultural production								
annual change in % (real)	4.3	1.3	-0.4	-0.2	2.2	.	.	.
Construction output								
annual change in % (real)	2.1	0.7	6.0	6.5	4.0	.	.	.
Employed persons, LFS, th, average	71,933	70,601	71,719	71,169	71,733	71,360	71,720	72,440
annual change in %	-0.8	-1.9	1.6	0.7	0.8	-0.5	0.5	1.0
Unemployed persons, LFS, th, average	3,465	4,321	3,631	3,969	3,074	3,000	3,400	3,300
Unemployment rate, LFS, in %, average	4.6	5.8	4.8	5.3	4.1	4.2	4.8	4.5
Reg. unemployment rate, in %, eop 3)	0.9	3.7	1.0	1.6	0.9	.	.	.
Average monthly gross wages, RUB	47,867	51,344	57,244	54,587	61,853	63,200	68,100	72,900
annual change in % (real, gross)	4.8	3.8	4.5	4.2	-0.8	-3.0	1.0	3.0
Consumer prices, % p.a.	4.5	3.4	6.7	5.8	14.3	13.9	6.7	4.0
Producer prices in industry, % p.a. 4)	2.0	-3.8	24.5	20.4	23.5	20.0	5.0	5.0
General governm. budget, nat. def., % of GDP								
Revenues	36.0	35.6	36.7	37.2	38.0	36.5	37.5	37.5
Expenditures	34.1	39.6	35.9	34.8	33.9	38.5	40.5	39.5
Deficit (-) / surplus (+)	1.9	-4.0	0.8	2.4	4.1	-2.0	-3.0	-2.0
General gov. gross debt, nat. def., % of GDP	12.4	17.6	16.0	15.6	13.3	13.0	15.0	15.5
Stock of loans of non-fin. private sector, % p.a.	7.1	14.4	18.8	18.0	6.2	.	.	.
Non-performing loans (NPL), in %, eop 5)	6.0	6.1	5.1	.	.	.	.	.
Central bank policy rate, % p.a., eop 6)	6.25	4.25	8.50	5.50	9.50	7.25	8.00	6.00
Current account, EUR m 7)	58,518	31,533	103,080	32,963	133,819	295,000	204,300	189,200
Current account, % of GDP	3.9	2.4	6.9	5.1	16.1	13.0	10.2	10.1
Exports of goods, BOP, EUR m 7)	374,738	291,760	417,102	193,064	301,687	623,300	551,200	551,200
annual change in %	-0.5	-22.1	43.0	15.7	56.3	49.4	-11.6	0.0
Imports of goods, BOP, EUR m 7)	226,668	209,726	256,766	142,901	146,773	265,600	277,700	291,600
annual change in %	7.4	-7.5	22.4	11.1	2.7	3.4	4.6	5.0
Exports of services, BOP, EUR m 7)	55,275	42,080	47,259	.	.	48,900	48,300	50,700
annual change in %	0.8	-23.9	12.3	.	.	3.5	-1.2	5.0
Imports of services, BOP, EUR m 7)	87,954	56,448	63,750	.	.	66,000	72,000	75,600
annual change in %	9.4	-35.8	12.9	.	.	3.5	9.1	5.0
FDI liabilities, EUR m 7)	28,548	8,296	33,639	9,405	-36,221	-48,500	.	.
FDI assets, EUR m 7)	19,574	5,117	55,061	14,765	-30,100	-38,800	.	.
Gross reserves of CB excl. gold, EUR m 7)8)	396,378	372,318	439,693	496,806	554,838	.	.	.
Gross external debt, EUR m 7)	438,757	380,941	426,062	397,058	447,126	432,300	341,400	299,100
Gross external debt, % of GDP	29.0	29.2	28.4	26.4	19.7	19.0	17.0	16.0
Average exchange rate RUB/EUR	72.51	82.39	87.20	89.54	83.31	65.0	75.0	85.0

Note: Including Crimean Federal District.

1) Preliminary. - 2) Excluding small enterprises. - 3) In % of labour force (LFS). - 4) Domestic output prices. - 5) According to Russian Accounting Standards overdue debt is defined as debt service overdue, therefore the data are not fully comparable with other countries. - 6) One-week repo rate. - 7) Converted from USD. Annual data for BOP unrevised. Half-year data for trade in goods and services together. - 8) Including part of resources of the National Wealth Fund of the Russian Federation. Half-year data including gold.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.