

BOFIT Forecast for Russia
28 March 2022

BOFIT Russia Team

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for Russia 2022–2023



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Russia's war on Ukraine is hurting the Russian economy. In light of instability and uncertainty in Russia, increased international economic and trade sanctions, as well as Russia's own countersanctions, we expect Russian GDP to contract by about 10 % this year and remain in the next few years at levels seen a decade ago. The ruble's exchange rate has fallen sharply, and Russia's imports are expected to halve to levels reminiscent of the mid-2000s. The volume of Russian exports will decline, particularly as the EU reduces its energy imports from Russia. High inflation will depress household consumption, and fixed investment will suffer. The risks to this forecast are exceptionally large and concern e.g. the war, sanctions, inflation and fixed investment. Government budget spending could grow strongly.

Attack on Ukraine will shrink the Russian economy

Russia's invasion of Ukraine has destabilised the Russian economy and fuelled uncertainty to very high levels, which already as such causes recession. The most significant immediate economic effects were a roughly 40 % drop in the ruble's exchange rate after the attack (50 % drop from last November) and a spike in inflation to record heights. Russian economic output and imports are contracting.

European Union countries and many others have imposed unprecedented economic and trade sanctions on Russia. The sanctions ban the export to Russia of many goods including various technology products, and certain services, as well as imports of select goods. The EU also set a goal recently to phase out energy imports from Russia in the next few years. The sanctions restrict further the access of Russian banks, firms and the government to finance, ban certain Russian banks from normal messaging of international payments (in SWIFT) and prohibit transactions with the central bank as well as owners of various companies and their companies. The impacts extend beyond countries imposing sanctions because firms that are part of global production chains and banks that look after their international financing networks are inclined to observe sanctions in order to avoid endangering the chains and networks. In an exceptional move, many foreign firms have voluntarily started to scale down or cease production and other business activities in Russia. Some are terminating trade with Russia or transport to Russia.

Russia's countersanctions that target imported and exported goods seem to appear gradually. Russia has restricted outward-bound payments made by foreign firms operating in Russia. Due to the unstable economic situation, strict constraints have been placed on Russian firms and citizens seeking to send payments abroad and obtain foreign currency. Russian firms are now required to convert 80 % of their export earnings to rubles. Recent talk about nationalising foreign firms operating in Russia have added to the threat and prevailing uncertainty.

We expect the Russian economy to contract even with higher prices for oil and other key export commodities produced in Russia. Although the price of Urals-grade crude oil has diverged to levels well below those of other benchmark grades in recent weeks, it has still

been some 20 % higher than the average Urals price in 2021. Anyhow, markets expect energy prices to fall especially next year.

The war in Ukraine is expected to end fairly soon. Deep mistrust in the Russian economy, international sanctions and Russia's countersanctions are assumed to remain in place throughout the forecast period. The EU's fresh energy goal means that EU energy imports from Russia are to decline steadily. The covid pandemic is expected to subside during this year. We do not expect the ruble depreciation to provide much support to Russian domestic production during the forecast period, and higher prices for imported goods weigh on corporate investments.

In the middle of very large uncertainties, we estimate that Russian GDP will contract by about 10 % this year, to the level seen in 2011–2012. The economy is not foreseen to turn to recovery next year as instability in Russia, sanctions and Russia's own restrictive measures are a strain. The long-term growth outlook, tepid already earlier at around 1–1.5 % a year, has now weakened further as it is even more unlikely than previously that Russia moves ahead with needed economic reforms. Russia's economy will for a fairly long time remain considerably smaller than earlier.

Russian imports are foreseen to decline by about half this year and then remain at that lower level during the forecast period. It may be possible to substitute some limited amounts of imports with domestic products, but unlike in earlier recessions, Russia's domestic production this time will suffer from disruptions as imports fall partly due to export bans imposed by foreign countries.

Falling private consumption and fixed investment

Private consumption is expected to fall this year to levels seen a decade ago as inflation increasingly erodes purchasing power and depresses real household incomes. Even before Russia's invasion, consumer price inflation was running at nearly 9 % p.a. With the ruble's collapse, inflation has accelerated, and it is anticipated to gain speed also with supply and production disruptions as well as higher world market prices. Russian inflation could reach at least 20 % this year even if impositions of price controls focused on basic necessities may be anticipated.

Distress in corporations will, like in earlier recessions in Russia, probably lead to larger cuts in real wages than employment. Nevertheless, unemployment is expected to rise. While Russia's leadership has during recessions paid special attention to preserving jobs also in corporations, mounting pressures to lay off employees could now lead towards unemployment benefits that are low and less costly than employment supports. Real wages in the government budget sector are also foreseen to decrease. Under the Russian constitution, pensions need to be adjusted to keep up with inflation while other social supports have already been scheduled to increase. Consumer credit turned to rise after the 2020 recession but is now likely to come to a halt.

Inflation will also depress public consumption. In order to mitigate harms, the country's leadership may also in the current downturn focus on easily implementable transfers of funds, i.e. social supports that will feed into private consumption and corporate subsidies that keep the economy going.

Fixed investment should contract to levels last seen a decade and a half ago. The business environment for private firms has become exceptionally unstable and lacks perspective. The decline in foreign corporate investment to a necessary minimum will be felt as

investment by fully or partly foreign-owned firms has represented almost 15 % of total investment. The leadership will likely seek to stave off a deeper collapse in fixed investment by increasing orders to oligarch companies and other private firms and commanding state-owned enterprises. While government budget sector investment may increase, the effects are likely to be relatively limited as it represents no more than about 20 % of total fixed investment. We expect to see an exceptionally large drop in inventories that significantly exacerbates the declines in GDP and imports.

Russian exports contract and imports plunge

Growth of the world economy basically offers favourable wind to Russian exports. However, the volume of Russian exports starts declining as the EU goal of reducing energy imports from Russia is pursued while a few other countries and large corporations have decided to stop importing Russian oil even sooner. While Russia may be able to shift a part of its oil exports to other markets, a particularly large part of its gas exports is tied to pipeline transmission. Russia's own export bans will reduce exports further.

The drops in GDP and the ruble's exchange rate have knocked down Russian imports in the previous recessions by up to 30 %. In addition to these two factors, imports will now also be reduced by bans on exports, payment restrictions and voluntary decisions by foreign firms to cease exporting to Russia. The expectation that imports fall by half this year means a decline to a level that was seen in the mid-2000s.

The ruble's exchange rate is expected to remain at its current level during the forecast period. The central bank is unable to support the exchange rate through purchasing rubles as the EU and US have prohibited transactions with the central bank. On the other hand, the fresh requirement for Russian firms to convert 80 % of their forex export earnings to rubles will provide coverage for payments going abroad, especially as imports have fallen sharply. The ruble's real exchange rate will gradually rise as Russian inflation will considerably outpace the inflation rates of its trading partners. Even so, the real exchange rate is weak, and its gradual rise is not expected to revive Russian imports very much.

Due to high export prices and falling imports Russia's current account surplus, which already last year reached nearly 7 % of GDP, will grow temporarily. The surplus will then shrink as export prices are expected to come down and EU countries cut back on their energy imports from Russia.

Government spending may increase; central bank takes care of banks

Russia's shrinking economy will pull down the government budget sector from a rather good position as a rapid rise of budget revenues from the 2020 recession turned the deficit into surplus last year. Although the economy is now shrinking, budget revenues will still this year increase markedly faster than inflation because budget revenues from dollar-based export tariffs and production taxes on oil & gas sectors (a fifth of government budget sector revenues last year) rise sharply in rubles due to the collapse of the ruble's exchange rate. Markets also expect oil & gas prices this year to remain higher on average than in 2021.

Other budget revenues will shrink this year due to the severe slump in the economy. High inflation beautifies the nominal figures but presses down these revenues in real terms. In the next few years, total government revenues will decline in real terms as the tracks of

oil prices and the ruble's exchange rate no longer support the revenues while inflation probably remains rather brisk.

Increases scheduled in government spending so far do not look very large, and high government revenues this year should thus keep the government budget in surplus. Real spending, however, declines significantly due to high inflation. Russia could afford further increases in government spending based on this year's high revenues, and possibly the liquid assets of the National Welfare Fund, the state's reserve fund. The liquid assets and last year's designated budget revenues to be transferred to the fund this year together amount to nearly 15 % of GDP with the ruble's current low exchange rate. Those funds are held in foreign currencies and are part of the country's foreign currency reserves. Their use is affected by the EU and US decisions to ban transactions with the central bank, but in Russia the intention is to handle the necessary conversions into roubles via arrangements between state and the central bank. To the extent that the government's normal funding sources would appear insufficient the state could resort to calls upon the central bank to fund government spending, a move that would further support inflation.

Soon after Russia's invasion, the central bank raised its key rate to 20 %, which staved off a run on household bank deposits. At the same time, the central bank increased liquidity supply to banks as much as needed and granted a variety of regulatory relaxations from the normal. State banks dominate Russia's banking sector, and there are means for also keeping other banks afloat. Nevertheless, the functioning of banks will stiffen as falling household and corporate incomes hurt deposit-formation and the weak economic outlook depresses bank lending.

Exceptionally large forecast risks

Most of the many large risks surrounding this forecast for the Russian economy are to the downside. Growth of the global economy and changes in oil prices could diverge from their expected paths. Developments in the war that Russia started are capricious. International economic and trade sanctions on Russia, as well as Russia's own countersanctions, could escalate and further hurt Russian exports and imports.

The impacts of interruptions in supply and logistics on Russian production and imports could be surprisingly large. Russian inflation could accelerate more than expected and continue longer than anticipated, which would further erode private consumption in particular. Fixed investment of private firms could stumble badly if, for example, giving orders to large firms is not successful.

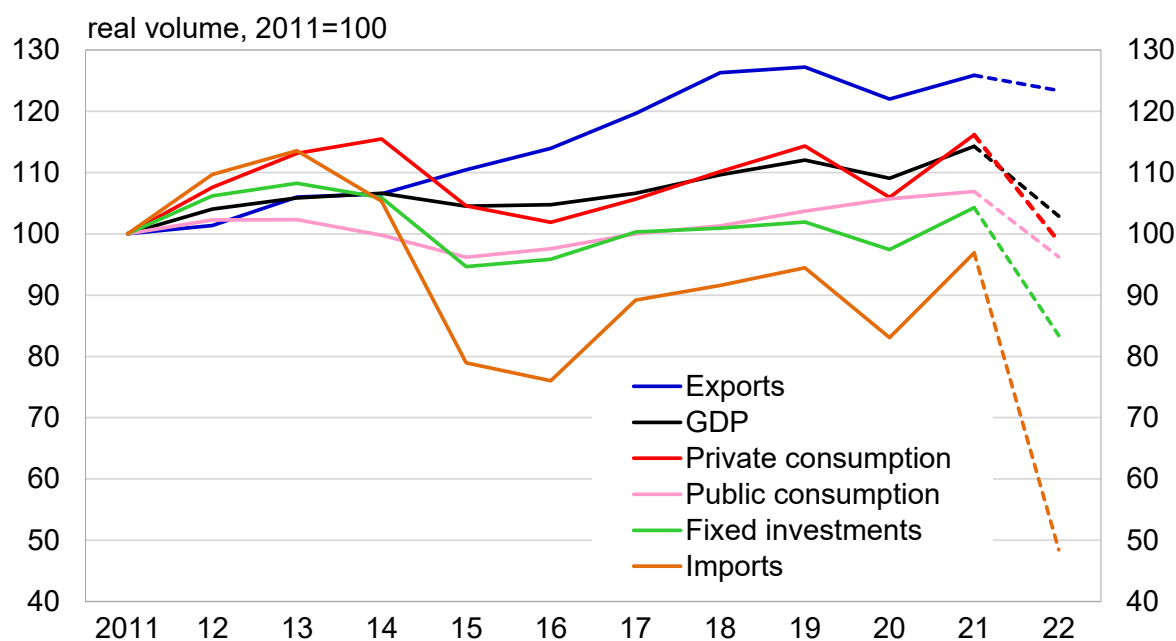
Government budget spending could increase significantly during the forecast period, increasing the likelihood of relying on the central bank to cover spending.

Table. Growth of Russian GDP, demand and imports: realised and forecast (f), %

	2018	2019	2020	2021	2022f
GDP	2.8	2.2	-2.7	4.7	-10
Private and public consumption	3.5	3.4	-4.9	7.1	-14
Fixed investments	0.6	1.0	-4.4	7.0	-20
Exports	5.6	0.7	-4.1	3.2	-2
Imports	2.7	3.1	-12.1	16.7	-50

Sources: Rosstat and BOFIT.

Chart. Supply and demand components of the Russian economy, 2012–2022



Sources: Rosstat and BOFIT.