

BOFIT Forecast for Russia
13 March 2023

BOFIT Russia Team

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for Russia 2023–2024



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An unprecedented fog of uncertainty

Russia's unprovoked invasion of Ukraine and the economic sanctions imposed on Russia drove the Russian economy to the verge of crisis in March 2022. The strong economic growth of January and February in 2022 quickly evaporated, and production in several sectors declined due either to lack of demand or unavailability of key components and inputs. The Russian government responded by raising public spending, particularly on public investment. Economic policy was overhauled to accommodate wartime conditions.

Russian GDP contracted by 2.1 % last year. For the current year, we expect an economic decline of similar magnitude. Uncertainty and sanctions should dampen domestic demand, and exports should diminish. Russia's economic stability relies on public-sector spending and war has placed the country on a risky path towards an autarkic economy with a heavy state footprint. This structural transformation is likely to reduce productivity and Russia's long-term economic growth potential.

A year of war causes a major shift in Russian economic policy

The invasion of Ukraine plunged Russia's economy, which was just emerging from the Covid-19 pandemic, into deep uncertainty. The fog of war, decisions by many Western firms to pull out of Russia altogether and escalating sanctions translated into dramatically weaker economic performance. The economy experienced its biggest shock immediately after the launch of the invasion with second-quarter GDP contracting by more than 5 % from the first quarter. According to Rosstat's preliminary figures, the economic contraction stopped sometime in the second half of 2022. For all of last year, GDP decreased by 2.1 %.

The rise in global energy prices last year supported growth in all oil-producing countries. Yet even with rising export prices, Russia was the only oil exporter to experience economic recession. In our pre-invasion forecast from autumn 2021, we expected the Russian economy to grow by about 2.5 % in 2022, noting that increases in Russia's main export products could spur even higher economic growth. As it turned out, the Russian economy last year was about 5 % smaller than we expected. This shrinkage might be seen as a rough approximation of the macroeconomic cost Russia paid for its first year of war.

Even so, Russia's economic contraction was less than we had expected in a year ago. While some of our forecasting error can be traced to the sharp rises in oil & gas prices last year, the flexibility of Russian corporations and the long transition periods for Western sanctions, the biggest reason was Russia's remarkable economic policy pivot. For over two decades, Russia's fiscal policy aggressively pursued budgetary prudence and deficit constraints. Exchange rate policy was anchored by a freely floating ruble and free movement of capital. All these principles went out the window as the government struggled to stabilise the economic situation at the end of February 2022. Financial markets were closed for a month and cross-border capital flows were severely restricted. When the markets reopened, assets of Western investors remained frozen, turnover on the Russian exchange was half of its pre-invasion level and the ruble had ceased to be a freely convertible currency.

The shift suggests that the government has no illusions about a quick return of foreign capital. Russia expects to rely on domestic financing sources for years to come.

The decline in government revenues and significant increases in expenditures caused by war made it impossible to balance the government budget even with robust oil revenues.¹ Last year's federal budget deficit was a manageable 2.2 % of GDP, and the shortfall was financed with the previous year's budget surplus, assets from the National Wealth Fund and issuance of domestic debt.

Public money is needed to cover the direct costs of war and to support the economy, particularly via investment subsidies, loans and guarantees. Most of last year's investment growth reflects growth in projects launched before 2022, as well as growth in public investment and investment projects supported by public funds. The government's budget financing for national projects, for example, swelled last year by 29 % (roughly 15 % in real terms). Some of the largest of these projects involved construction of transportation infrastructure. In addition, many war-related projects were likely booked as public investments. Such investments boost Russian GDP, but their contribution to the national welfare is dubious.

The top economic policy goals during the first year of war were minimising the impacts of sanctions and decoupling from the West. It was also made clear that the economic transition to a new normal would not be entrusted to market forces. As a consequence of the invasion, the state's role in the economy and society has increased. Large firms in particular are increasingly subject to the whims of those in power. Economic policy choices taken last year pushed the economy onto a path towards a war economy.

Economic recession to persist throughout 2023

With the uncertainty of war and sanctions quelling domestic consumption, we expect no growth in private consumption this year. Unemployment should remain near historical lows, especially if the government continues with its partial mobilisation of military reserves, which has led to large numbers of people leaving the country. Large-scale layoffs are also likely to be treated as unpatriotic acts.

Many large and mid-sized corporations were profitable last year. In principle, this should support wage growth this year, but business performance has been quite mixed across sectors of the economy. Sanctions have slammed firms dependent on exports and imports (e.g. carmakers and the wood processing industry). The automobile industry last year employed roughly 245,000 people, just under 5 % of Russia's manufacturing labour force. The number of people working in the wood processing industry was about 122,000. About a third of companies in these two sectors posted losses last year. Moreover, these struggling industries tend to be concentrated in specific regions, further exacerbating regional disparities in real wage development. Wages were up sharply last year, particularly in some of the poorer regions of the Urals and Siberian Federal Districts, as well as Buryatia in the Far East Federal District. In contrast, average wages in rich regions of the Central Federal District such as Moscow and Kaluga failed to keep pace with inflation.

We expect public consumption to increase this year, especially in internal security and defence. At the same time, declining oil prices and economic recession should significantly reduce public sector revenues. We therefore expect this year's budget deficit to well

¹ These large oil and gas revenues include the large windfall tax imposed on Gazprom in late 2022. The revenue raised from this one-time tax corresponded to just over 0.8 % of GDP.

exceed the budgeted deficit of 2 % of GDP. The public sector deficits this year and next can be financed with assets from the National Wealth Fund,² issuance of domestic debt securities, increased taxation of private firms and central bank funding as a last resort, but even domestic funding has its limits. Over the medium term, Russia needs to cut public-sector spending or find new revenue streams.

As projects begun before the war reach completion this year, we expect fixed investment growth to slow. Western sanctions on Russian oil exports and a general drop in global oil prices will also thin the revenue streams of Russia's largest energy producers. The government's import substitution plans, however, call for new investment in domestic production facilities. The foreign trade shift to the east and south will also require vast infrastructure investment that depends on ongoing public support. Moreover, continuation of the war necessitates greater defence spending and investment in military industries. The country seems bent on directing increasingly scarce labour and capital to branches where productivity is questionable at best.

Russian imports should be slightly higher this year compared to the realised level of 2022, but given that sanctions continue to restrict import possibilities, a strong recovery in imports is very unlikely. Further, as oil & gas revenues decline, imports will not be supported by a strengthening rouble exchange rate. The volume of exports is forecast to contract, largely on declining oil & gas exports. This is due not only to the EU's import restrictions on crude oil and petroleum products, but also Russia's decision to restrict pipeline natural gas exports. As a result, net exports will have a negative impact on GDP development this year.

The contraction in the volume of exports may be smaller than we previously predicted. Some of this reflects the G7's price-cap mechanism imposed in December 2022 (crude oil) and February 2023 (petroleum products). To prevent upsetting global energy markets, the mechanism was designed to reduce export prices for Russian crude oil and petroleum products, not to reduce export volumes.

We expect Russian GDP to contract a further 2 % this year. Without significant changes in the war situation or sanctions regime, we see Russia experiencing close-to-zero economic growth in 2024. The medium-term growth outlook depends above all on how the war eventually ends.

Table 1. Annual change in Russian GDP, %

	2019	2020	2021	2022	2023
GDP	2.2	-2.7	5.6	-2.1	-2
Domestic consumption	3	4	8	-1	-1
Capital formation	2	-4	14	-3	0
Exports	1	-4	3	-	-5
Imports	3	-12	19	-	5

Sources: 2019–2022 figures from Rosstat, 2023 BOFIT.

² As of end-2022, the assets in Russia's National Wealth Fund were valued at 10.435 trillion rubles (148 billion dollars), or roughly 7 % of GDP. The Fund's liquid assets consist largely of yuan-denominated deposits and securities, as well as the central bank's gold reserves. Liquid assets at the start of 2023 amounted to roughly 6.133 trillion rubles (87 billion dollars), or about 4 % of GDP. The value of the liquid assets held by the National Wealth Fund as of end-2021 equalled roughly 6 % of GDP.

Russia's emerging wartime economy

Russia's decision to attack Ukraine has pushed the Russian economy towards structural reversion to an autarchic economy. To succeed, this shift implies significant investment in domestic production and new transportation routes. It also implies increased military production that likely persists as long as the current administration remains in power. This shift unavoidably deprives other sectors of the economy of resources, limiting their ability to take advantage of more productive investment opportunities.

This structural adjustment involves the channelling of economic resources away from service industries to the defence industry and industries that produce goods for the domestic market. The lack of foreign components and inputs raises production costs and forces companies to rely to some extent on poor-quality materials. Another consequence of the structural change is the simplification of final products. Russian car manufacturers, for example, now reportedly produce cars without airbags and other standard features. Adjusting to wartime conditions and import substitution naturally varies from branch to branch and even business to business. This structural change is likely to cause declines in Russian productivity and the country's long-term potential growth trend. Recent estimates put Russia's long-term growth potential below 1 % a year.

The transition from a market economy to a wartime model will also make it more challenging to monitor and analyse Russian economic developments. Possible impacts from sanctions can be hidden by official decree or government support measures. Traditional economic indicators such as gross domestic product may also become less meaningful. GDP only measures value added of production, not its welfare effects. Adjusting GDP calculations for product quality is a non-trivial task. The substitution of high-quality Western imports with low-quality domestically produced components is unlikely to be fully reflected in the national accounts. While war increases military production, the destruction caused by the invasion does not appear in Russia's national accounts. If anything, war may boost the aggressor's GDP numbers.

The sustainability of Russia's public finances and the course of the war are the largest risks in our forecast. We assume that Russia will have little trouble covering its fiscal deficits in the near future. However, the government cannot continue to pile on debt for long without stoking inflation and depressing private investment. It is possible that the government manages to recalibrate spending to a more modest burn rate as private-sector growth recovers. Under current conditions, however, the likelihood of such a scenario playing out is impossible to judge.

If private activity does not pick up, the government may find it difficult to reduce public spending. In this scenario, budget deficits must increasingly be funded through domestic debt issues. Constant increases in government debt could significantly complicate corporate access to financing and slow the recovery in private-sector investment. Public entities (the central government and a few large regions) already account collectively for over half of all bonds issued in Russia. On the other hand, increased central bank financing could fuel unmanageable inflationary pressures that may trigger a new financial crisis. It is difficult to reconcile an economic path that involves decoupling from the West and maintaining a war footing with a separate path that delivers sustained economic growth and a better standard of living for average Russians. After a year of war, it seems that Russia's economic policymakers have chosen the first path. The final consequences of this decision will only become visible several years from now.