BOFIT Forecast for Russia
14 September 2023

BOFIT Russia Team

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Bank of Finland
BOFIT – Institute for Emerging Economies

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PO Box 160
FI-00101 Helsinki
Phone: +358 9 1831
bofit@bof.fi

www.bofit.fi/en

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For the first half of this year, Russia's economy clearly outperformed our previous forecast. While much of the up-side surprise came from private consumption and fixed investment fuelled by massive growth in public spending, the current numbers also reflect last year's low reference basis.

Our forecast update is based the latest GDP figures from the Federal State Statistics Service (Rosstat). Due to the high growth in public spending and last year's low reference base, growth this year should come in at around 2 %, even with quarterly growth in the second half slowing down significantly. We expect on-year growth of close to one percent next year.

This year's growth spurt is mainly a result of higher public spending and increased bank lending. The resulting strong growth in demand has boosted capacity utilisation in many branches to historical highs and driven unemployment to historical lows. Mobilisation and emigration have exacerbated Russia's already chronic labour shortage caused by demographic trends. Economic activity has recovered to near pre-war levels and sanctions continue to limit imports, particularly imports of investment goods. Russia clearly lacks the prerequisites to sustain the current high-growth episode.

Our current forecast is subject to exceptionally high uncertainty. A slight increase in quarterly growth during the second half of this year or a revival in fixed investment would increase the pace of 2023 GDP growth above our current projection. On the other hand, Russia is hitting the limits of growth and there are already signs of cooling growth in private consumption. Russia's war of aggression has grated on the external operating environment, making it harder to predict responses from the international community. There is a real risk of significantly larger negative impacts on foreign trade than we assume in this forecast. Sanctions have already restricted imports of high-technology goods that can potentially be used for military purposes, and capital continues to flow out of Russia. Finally, any major shift in the war could significantly alter the trajectory of Russia's economic development.

Table 1. Annual change in Russian GDP

	2020	2021	2022	2023	2024
GDP	- 3 %	6 %	- 2 %	2 %	1 %

Sources: Rosstat figures for 2020-2022 released on 7 April 2023; BOFIT updated 2023–2024 forecast figures released on 14 September 2023.

Ever-greater share of economy dependent on government funding

Public sector support measures have helped the Russian economy recover much faster than we expected from the initial post-invasion shock of spring 2022 and plunge in GDP. War inevitably raises government spending, and in Russia's case, direct costs of warfare increase domestic economic activity. Most military procurements go to domestic suppliers, forcing firms serving the military to compete for the limited pool of workers by offering attractive wage and benefit packages. Salaries and other compensation paid to mobilised reservists and their families are also considerably higher than average earnings during peacetime. War pay has been a boon to retail sales and demand for services, especially in Russia's poorer regions. Government interest subsidies have also accelerated growth in the bank lending stock, especially in mortgages. An ever-larger share of economic growth is dependent on direct and indirect government support.

Fiscal restraint, free movements of capital and development of the market economy are hardly the touchstones of Russian economic policy in the forecast period. Prosecuting the war has become Russia's top priority, and in this sense, Russia has already shifted to a wartime economy. The government sees its main role as securing the resources needed for making war. It can thus mobilise public and private sector assets and agents as it sees fit.

A wartime economy compresses the time frame for policy planning. In this sense, the Russian government can ignore public sector imbalances for the rest of the forecast period. After all, last year's deficit for the entire public sector (federal, regional and local budgets plus off-budget funds) was 2.108 trillion rubles, or about 1.5 % of GDP.[1]. Russia can easily afford similar (or even larger) shortfalls in coming years. It can raise corporate taxes, increase borrowing or even turn to direct central bank financing. In any case, the problems accumulated from such deficit financing can be passed on to post-2024 world.

Nevertheless, the pace of public spending growth will not remain at levels of the first half of 2023. We expect the volume of government consumption for all of 2023 to increase significantly from last year. Some growth in public spending will support public investment, and we now expect volume of fixed investment to grow at about the same pace than last year. Spending on wages and social supports will reinforce private consumption, which we expect to grow substantially this year.

Growth in public consumption next year should be quite modest. A slowing pace of public spending growth, in turn, implies lower overall economic growth next year. If Russia still needs to increase its military spending, budget cuts in areas other than social supports can be considered after the March 2024 presidential election in Russia.

Limits to growth

The recovery in domestic demand and exodus of foreign firms from the Russian market have added pressure to increase imports. Western sanctions and the Russian government's import-substitution policies, however, continue to hamper the imports of many goods and services. We do not expect the volume of imports to return to pre-invasion levels during the forecast period.

The acceleration in inflation in recent months suggests that domestic producers of goods and services have troubles in keeping up with rising demand. This is corroborated by historically high capacity utilisation rates and record-low unemployment (3 % in July). Growth in domestic demand and ruble depreciation have also lifted inflation expectations over the long term.

[1] The 2022 federal budget deficit was much larger, 3.295 trillion rubles, or about 2.1 % of GDP. The federal budget deficit for the first half of 2023 was already 2.35 trillion rubles.

It is extremely unlikely that Russia will sustain its current high growth levels next year. With war draining the supply of young men from the labour pool, growth would have to be driven by increased fixed investment. Growth in Russian fixed investment at the moment seems concentrated in manufacturing branches that support the military-industrial complex. Increases in production capacity in these branches are unlikely to support growth in living standards over the long term. As resources are scarce, particularly labour resources, it is more likely that rapid growth in defence-related industries will cause slowdowns elsewhere in the economy. A sustained war stance will make the Russian economy more isolated and increasingly state-driven.

Table 2. Some of the main economic indicators for Russia tracked by BOFIT

	2020	2021	2022	2023	Latest observation
Industrial output, % change y-o-y	−2.1	6.3	−0.6	2.6	1–7/2023
Fixed investment, % change y-o-y	−0.1	8.6	4.6	7.6	1–6/2023
Retail sales, % change y-o-y	−3.2	7.8	−6.7	2.4	1–7/2023
National Wealth Fund, USD billion	183	182	148	143	8/2023
Annual inflation, % change	3.38	6.69	13.75	5.3	8/2023
M2, % change y-o-y	14.1	10.7	19.4	25.0	7/2023
Average price for Urals oil, USD/bbl	41.6	68.8	76.0	56.6	8/2023

Source: BOFIT statistical database for Russia.

Box: Why the major forecast revision?

Available data show the Russian economy clearly outperformed our previous forecasts. Indeed, all major institutional forecasters have had to revise upwards their estimates for Russian medium-term growth. Four factors may help explain our need our revised outlook.

1. Fundamental shift to wartime economy

The verities of economic policy cease to apply when a government prioritises war over all else. Russia’s decision last year to dispense with two decades of prudent economic policies caught many by surprise, not just forecasters. In late February 2022, Russia abandoned free convertibility of the ruble and imposed capital controls to mitigate the impact of financial market sanctions imposed by Western countries. At the end of 2022, Russia embarked on an unprecedented episode of increased public spending to support the war effort directly and indirectly. Rosstat’s figures for the first quarter of 2023 indicate that public consumption rose by 14 % y-o-y in demand-side GDP categories. This huge jump in government spending defied our conventional expectations.

Moreover, economic policy in Russia is now rarely discussed openly. Policy decisions may come down without warning, catching economic agents flat-footed or simply bewildered. For this reason, changes in economic policy and the prioritisation of the war effort will continue to add uncertainty to the efforts of economic forecasters.

2. Data unavailability

With reduced access to our Russian colleagues, researchers and analysts, we must rely increasingly on official statistical data. While Russian officials continue to release large amounts of economic data, information about foreign trade and government spending (and most recently oil production) is increasingly scarce. This lack of data availability makes monitoring developments in the Russian economy challenging to say the least.

Changes related to goods exports and imports must be pieced together from the mirror statistics of Russia's main trading partners. Mirror figures give a relatively good and timely assessment of the value of Russian exports and imports, but GDP figures require information about the volume of exports and imports. According to data released by Rosstat in April, the volume of Russian exports declined by 14 % in 2022, a change that few outsiders foresaw.

3. Rebound in private consumption

Increased public spending has been the main driver of the adjustment in our current outlook for Russia, but also private consumption surprised on the upside. Once again, Russian economic agents proved themselves able to deal with sudden shocks. This ability to adjust to changed circumstances is partly the outcome of Russia's poor business environment. Companies often have to maintain large inventories, tolerate significant overstaffing, and keep substantial assets in reserve to deal with bureaucrats or competitors.

War also degrades the business environment by increasing structural distortions. The role of the military-industrial complex and state enterprises in the economy grows, tilting the playing field against private sector. As imports decline, competition withers and the economy becomes increasingly isolated from the rest of the world. Even with the recent burst of growth, further growth prospects are bleak.

4. Change harder to quantify

With the tightening of political control in Russia, we need to be circumspect about official figures. Although observers find no evidence of systematic efforts to distort the reported data, the shift to a wartime economy causes structural changes that are difficult for even the most seasoned statistician to capture. GDP figures during war obviously describe economic behaviours different from peacetime. Uncertainty increases the longer the war lasts, making forecasting harder as last year's figures on which this forecast is based are already sketchy.

For this reason, our current forecast only provides a few round numbers (nothing after the decimal point). Our goal here is simply to explicate trends, not give precise figures.