BOFIT Forecast for Russia
25 March 2024

BOFIT Russia Team

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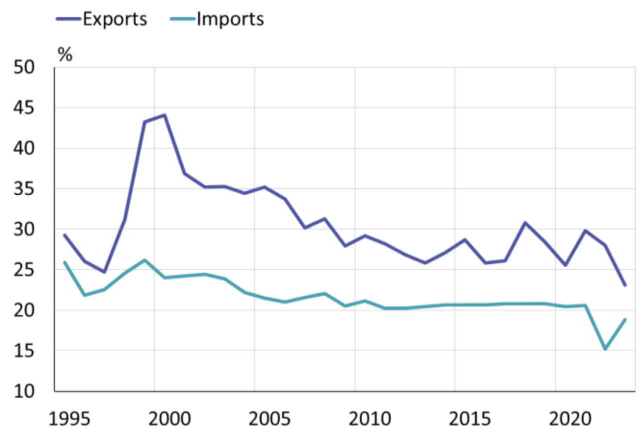
Russia's positive 2023 economic growth defied predictions. Growth in the capital stock and private consumption were both higher than expected. Part of the significant growth in the capital stock reflects soaring defence industry investment, as well as companies stocking up for uncertain times ahead and preparing for dwindling availability of components. The rapid growth in private consumption last year partly reflects the low reference basis of 2022 and substantial wage hikes. With Russia already experiencing severe capacity constraints, growth this year is expected to decelerate. Russian economic growth in the years ahead will remain subdued and fuelled mostly by government spending. Russia's long-term potential growth rate, in particular, has been reduced by the shift to a wartime economy.

Russian economic growth will decelerate this year. High growth of the second half of 2023 is still sufficient to boost on-year growth this year to around 2 %, even if quarterly growth were to cease altogether in 2024. In the absence of a surprising event, the Russian economy in 2025 and 2026 should grow at around 1 % a year, close to its long-term potential growth rate.

Growth last year was driven by higher public spending, increased bank lending and greater private consumption spurred by wage hikes. The post-invasion drop in economic activity in 2022 proved to be less serious than expected, which makes the growth spurt in 2023 even more surprising. While sanctions depressed exports, import opportunities improved from 2022. This had a more negative impact on GDP than anticipated. The value of Russian exports based on prevailing prices last year amounted to a mere 23 % of GDP, the smallest share in Russia's post-Soviet statistical record and a stunning indicator of how isolated the country has become.[1]

Figure 1. Russian imports and exports as a percentage of GDP, 1995–2023**.**



Note: Figures after 2011 are not directly comparable over time due to methodological changes.
Sources: Rosstat and BOFIT.

[1] Russia has not released data on export and import volumes since 2022.

Labour shortages have become one of the biggest bottle necks to Russian economic growth. Part of the problem is Russia's poor demographic situation. Russia's labour force has been shrinking for over 15 years. Partial mobilisation of reserves and emigration from Russia have only made the situation worse. While unemployment has fallen to record lows, Russia has a dire need for both highly educated and low-skilled workers. Brain-drain and working-age persons leaving the country have hardly helped the situation.

Capacity utilisation has been at historically high levels since 2021, and sanctions are further restricting imports of investment goods. Russia's efforts at import substitution are unlikely to make up for the deficit in production capital. A large portion of the growth in fixed capital investment this year and in coming years will go to military machinery & equipment, i.e. investments without potential to create a basis for sustained high growth in the future. By the same token, robust growth in the construction sector partly reflects financing of new military infrastructure, production facilities and fortification construction. Rapid growth last year will be impeded this year by rising interest rates for civilian construction and the reduced availability of subsidised-interest loans.

Uncertainty in the current forecast remains high. Marginal on-quarter growth in the first half of this year could raise the figure for 2024 GDP growth overall above our forecast. If strong growth in private demand continues, growth would exceed our current expectations both in 2024 and 2025. A sudden change on the Ukraine-Russia battlefield could also weaken Russia's economic development more than forecast as the non-war parts of the economy would be impacted as a larger share of funds would be channelled to the war effort.

Forecast uncertainty has been heightened by the unavailability of critical statistical information. For example, Russia has ceased to publish an itemised state budget, oil output figures or changes in foreign trade volumes. The lack of insight into what is happening at present in the Russian economy complicates the forecaster's task immensely (see recent BOFIT blog piece that delves into forecasting challenges since the Ukraine invasion).

Table 1. On-year change in Russian GDP, %.

	2021	2022	2023	2024	2025	2026
On-year change	5.9	−1.2	3.6	2	1	1

Sources: Rosstat figures for years 2020 through 2023 and up to Feb. 7, 2024; BOFIT projections for years 2024 through 2026 starting March 25, 2024.

Growth increasingly reliant on government spending

The federal budget plan calls for brisk growth in public spending this year. A very large share of the increase in public spending will be channelled to the war effort in a variety of forms, including fixed investment. On the other hand, growth in market-based investment is expected to slow due to high interest rates, rising labour costs and likely tax increases.

War spending under the 2024 federal budget will exceed social spending the first time in post-Soviet history. Thanks to massive state-funded projects, Russia's war of aggression has revived demand on the domestic market. Some of the most substantial pay increases have been seen in branches connected to the war effort. In addition to those directly involved in war activities, above-average pay increases and benefits have stimulated demand in consumer sectors.

Financing of the war effort remains the government's top priority, even if the amount of social spending in the federal budget has also increased and will still receive strong emphasis throughout the forecast period. The deficit of the 2023 consolidated budget (comprises federal budget, regional budgets and off-budget funds) was 3.91 trillion rubles, or about 2.3 % of GDP. In the absence of drastic surprises, Russian state will be able to sustain similar deficits during the forecast period.

To finance the war effort, the Russian government is prepared to abandon earlier fiscal and monetary policies characterised by conservative budget rules and inflation targeting.

The significant wage hikes of 2023 are unlikely to repeat this year and growth in private consumption slows down. Furthermore, lending criteria have been tightened as part of the Central Bank of Russia's macrostability targets. These targets, however, are subject to the wartime economy and the related need for maintaining social cohesion.

Limits to growth to be reached in the coming years

Continued high growth in 2025 and 2026 is very unlikely. According to state budget plans, public sector demand will fall in 2025, and private market-driven investment is unlikely to offset the decline. On the other hand, the limiting of public-sector demand may be an impossible challenge since the public sector has assumed a dominant role in the Russian economy. Public demand in 2025 and 2026 is hard to predict as it is heavily influenced by Russia's military situation.

Private consumption will continue to grow due to labour constraints, albeit at a slower pace. Net exports, however, are expected to have a neutral impact on economic growth in the out years of this forecast. We assume that the effect of sanctions on Russian oil exports will remain at the level of early 2024 throughout the forecast period.[2] The price of Brent crude is expected to remain near the 2023 average level of about $83 a barrel.

The pickup in inflation last year indicates that Russia's domestic producers of goods and services could not keep up with rising demand and that some sectors of the economy were overheating. In response to the rapid inflation since spring 2023, the CBR has raised its key rate several times to its current level of 16 %. Russia's record-high capacity utilisation and record-low unemployment rate (under 3 % in December 2023) also point to economic overheating. State spending will increase considerably in 2024 mainly due to war-related expenses, which will certainly hamper measures to bring down inflation levels.

To achieve continuous growth significantly above the long-term potential growth rate will require redirection of capital investment to civilian uses along with significant productivity gains. This goal becomes all the more elusive due to the fact that the Russian population, and particularly the pool of young men available to the labour market, keeps shrinking. Certain large infrastructure projects, especially those in Russia's Far East, are likely to be implemented due to the massive need for logistical and transport infrastructure in the East. Due to the small populations in Russia's Far East and rudimentary infrastructure, growth in Russia's easternmost regions will be insufficient to make up for the drop of economic activity in the western parts of the country. A considerable share of investment in coming years will continue to focus on the war effort. Military investment goods are consumed rapidly and are unlikely to increase the economy's overall output capacity.

[2] The average difference in the beginning of 2024 between Russia's two main crude oil export grades (Urals and ESPO blends) and the lighter Brent blend used as an international reference was $14 per barrel according to the International Energy Agency. This gap provides a modicum of insight into the effectiveness of Western sanctions on Russian oil exports.

Table 2. Key economic indicators (BOFIT's Russia statistical database).

	2020	2021	2022	2023
Industrial output, on-year change, %	−2.1	6.3	0.7	3.5
Fixed investment, on-year change, %	−0.1	8.6	4.6	10.0
Retail sales, on-year change, %	−3.2	7.8	-6.7	6.4
National Wealth Fund, USD billion	183	182	148	133
Inflation, on-year change, %	3.4	6.7	13.8	5.9
M2, on-year change, %	14.1	10.7	19.4	23.1
Average Urals blend price, USD/bbl,	41.6	68.8	76.0	62.8

Source: BOFIT statistical database for Russia.