BOFIT Forecast for Russia
1 October 2024

BOFIT Russia Team

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Bank of Finland
BOFIT – Institute for Emerging Economies

Bank of Finland
BOFIT – Institute for Emerging Economies

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

www.bofit.fi/en

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Russia has posted a stronger-than-expected economic performance in the first half of 2024. Defying our earlier forecast, the capital stock and private consumption grew more rapidly than expected. Accordingly, we have revised upwards our growth outlook to 3½ percent for this year. In the second half of this year, we expect slowdown in economic growth due to Russia's stretched labour supply and production capacity constraints. Russian economic growth should decelerate further in 2025 and 2026 to around 1 % p.a., a level close to the economy's long-term potential growth rate. Higher growth would require a substantial increase in productivity, which seems unlikely given that a considerable share of investment is already dedicated to branches serving the war effort either directly or indirectly. Tighter sanctions have also impaired Russia's access to critical technologies.

Signs of slowdown after a high-growth episode

Russia's first-half economic growth exceeded our previous projections. This was due to strong private demand boosted by hefty wage increases and strong growth in loans. The expan-sions in government spending[1] has boosted economic growth much like during the two pre-vious years.

Signs of slowing economic growth became evident in the second and third quarter. Despite roaring growth in military-linked manufacturing branches, weakness in the extractive sector dragged down industrial output. Growth in construction, services and retail sectors has also decelerated.

Economic growth to decrease significantly in coming years

Even with a slowing economy, the robust growth legacy of the first half is sufficient to project overall growth of 3½ percent this year. In 2025–2026, we expect Russian economic growth to fall to just above 1 % a year, a level close to the economy's long-term potential growth rate. Russia's already low potential growth has been degraded by effects from Russia's war of aggression[2]. We assume that sanctions pressure will be maintained at the autumn 2024 level throughout the entire forecast period.

The initial burst of private consumer demand has been the key factor driving economic growth this year and will remain as the key contributor to growth throughout forecast horizon, albeit at a slower pace during 2025–2026. Consumer demand growth will be driven by high wage growth exceeding inflation as employers struggle to attract workers in a tight labour market. Strong growth in consumer lending witnessed this year will decelerate due to tightening of the macroprudential policy by the Central Bank and high interest rates.

[1] Spending in Russia's consolidated budget (incl. federal and regional budgets and extra-budgetary funds) rose 18 % y-o-y in the first seven months of this year.

[2] For more on Russia's long-term growth prospects, see Gorodnichenko, Korhonen and Ribakova (2024).

The CBR raised its key rate in September to 19 % in an unambiguous move to quell inflationary pressure.[3]

The growth in public sector consumption will continue to be strong over the forecast horizon. According to preliminary unofficial information, the estimate of the 2024 budget deficit will rise slightly to 1.7% of GDP (in June, the estimate was 1.1% of GDP). Russia's 2025 state budget and the 2026–2027 budget plan will be discussed in the Duma in the near future. Federal budget expenses are expected to increase in 2025 according to the revised plan. The biggest change would be to the draft 2025 budget, where military spending would be increased strongly to new record highs, whereas the previous plan contained large cuts to military spending. According to this draft, military expenses would comprise of 6.2 % of GDP in 2025 and decline to 5.6 % in 2026.

Despite the increase in military spending, the 2025 federal budget deficit is projected to shrink to 0.5 % of GDP and widen to 0.9 % in 2026. On the revenue side, increases to the Russian state budget are also planned. According to official preliminary information revenues of the federal budget would increase by 12 %, which is estimated to be less than the growth in expenses. The tax changes that will come into effect in 2025 are estimated to bring additional income to the consolidated budget (incl. federal and regional budgets and extra-budgetary funds) in the amount of approximately 1.3 percent of GDP. Russia still has funds to cover larger expenses. The liquid portion of the Russian National Welfare Fund was 4,800 billion rubles or 2.5 % of GDP at the end of August 2024. However, a significant increase in public consumption weakens measures aimed at curbing inflation. These changes in budget plans show how changes in public spending are strongly influenced by the development of the war situation, which is difficult to predict.

Fixed investment growth will still rise, but at a much slower pace. Only investment in industries directly involved in the war effort will be sustained at high levels, even though the major surge in fixed investment has likely passed. Growth in fixed investment in branches supporting the war effort and import-substitution policies should remain strong due in part to government loan subsidies and tax breaks. Notably, the rise in interest rates has not slowed down the growth of the corporate loan portfolio, which points to a relatively large proportion of fixed rate and subsidized loans. The forms of state support vary, among others, from fixed interest rate loans to state guarantees and low-cost loans through state development banks. In general, fixed rate corporate loans make up more than half of the loan portfolio, and a quarter of these are state-subsidized loans.

However, conditions for market-based investment are weakening this year and in coming years. High labour costs, difficulties in finding adequate substitutes for imported technology and the impending tax increases next year should diminish corporate cash flows.

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

	2021	2022	2023	2024	2025	2026
On-year change	5.9	−1.2	3.6	3½	1	1

Sources: Rosstat figures for 2020 through 2023 and up to September 13, 2024; BOFIT projections for 2024 through 2026 starting from October 1, 2024.

[3] In its July attempt at restraining galloping inflation, the CBR raised its key rate by 400 basis points and set key-rate target ranges of 14–16 % for 2025 and 10–11 % for 2026. The moves signalled a much more restrictive monetary stance than we had anticipated just a couple months earlier.

No major shifts in the volume of Russian exports – particularly drops in the volumes of top exports – are expected during the forecast period. Demand persists for crude oil, Russia's biggest export commodity, and the main buyers of Russian energy commodities, China and India, are unlikely to reduce their purchases. Looking at oil futures contracts from September 23 this year, we ascertain that the average price of benchmark Brent crude oil should settle at $82 a barrel this year and decline to an average of around $71-72 a barrel in 2025–2026. The discount on Russian Urals blend crude oil relative to the Brent price should also hover around $12 a barrel as long in sanctions pressure on Russia remains at the current level.

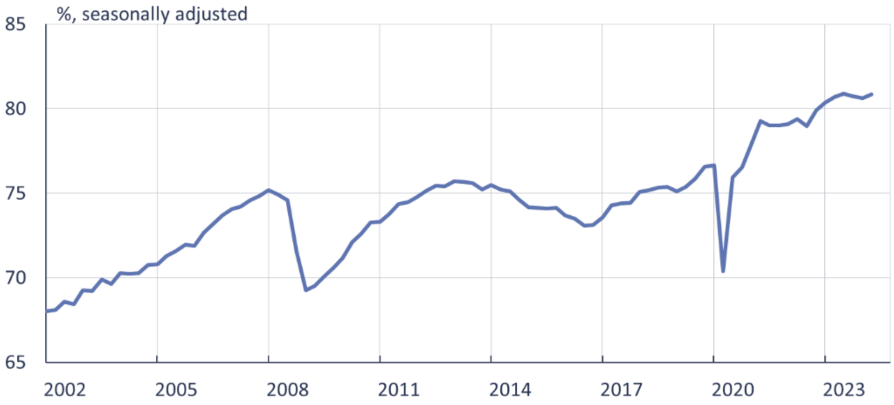
Import volumes this year should shrink from 2023. Russian imports have been hampered by sanctions and difficulties with international payment transfers. The value of imports declined by 5.5 % y-o-y in the first eight months of this year. The threat of sanctions targeting third-country financial institutions doing business with Russia have proven particularly effective in preventing Russian international transactions, or at least raised the cost of circumventing sanctions.[4] Lower imports will boost net exports, which in turn will have a positive effect on Russia's current account this year and a neutral impact in 2025 and 2026.

Supply-side restrictions more binding

Supply-side restrictions may be the darkest clouds in Russia's economic future. Russia, which has struggled with supply-side issues for years, has reached the point where strained production can no longer keep up with demand. This is manifested as high – and accelerating – inflation, which has gone from a 12-month rate of increase of just over 2 % in April 2023 to over 9 % in August 2024. The lack of workers, production capacity constraints and restrictions on imports should impact growth for the rest of this year and in years to come.

Russia's capacity utilisation rate, which has grown rapidly since 2021, has reach historically unprecedented levels. Industry operates flat out as sanctions have limited access to new machinery and equipment (and spare parts in particular). The situation has deteriorated since the end of 2023.

Figure 1. Production capacity utilisation.



Sources: CBR and BOFIT.

[4] Sanctions packages of November 2023, particularly threatened US sanctions on third-country financial institutions and corporations in countries that trade heavily with Russia (e.g. China, Turkey and the United Arab Emirates) have proven quite effective in degrading Russian supply chains involving sanctioned inputs. These financial sanctions were expanded further this year.

High risks persist over the course of the war and changes in fiscal policy

Uncertainly remains high also in this latest forecast. Trends for the Russian economy could degrade suddenly if the war takes a sudden unfavourable turn for Russia. In such case, the cost burden of the war effort would then crowd out resources from the non-mobilised branches of the economy.

The strong performance of the Russian economy over the past two years has defied predictions, especially with respect to government spending and private consumption. Current deficits are so far at sustainable levels, and consumers, especially this year, have been able to both save and increase spending. However, deviating from measures to stabilise government budgets only fuels an already overheated economy. As always, the price of crude oil on global markets remains a likely source of both upside and downside risks for the Russian economy.

Another contributor to forecast uncertainly is the unavailability of important datasets used in preparing forecasts prior to Russia's invasion of Ukraine. Importantly, Russia has ceased to publish details government spending data, oil production statistics or data on changes in foreign trade volumes. Lack of data on current economic conditions is an unfortunate obstacle to routine analysis and adds to forecast uncertainty.