RUSSIA: Entering the deepest crisis since the early nineties[37]

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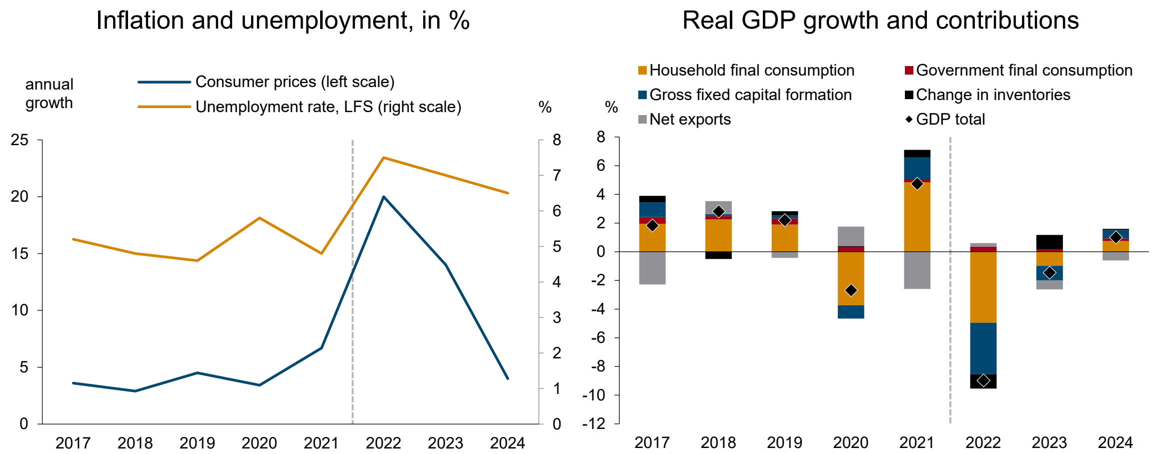
Tough Western sanctions in response to the Russian invasion of Ukraine will push the economy into deep recession this year and possibly next. Thanks to wide-ranging capital controls and monetary policy tightening, financial stability has been restored, and the rouble has recovered to nearly pre-war levels. However, the full effect of trade sanctions has yet to unfold and, along with the withdrawal of many foreign firms, this will hamper long-term growth prospects.

Figure 4.18 / Russia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Last year, the economy successfully emerged from the COVID-related slump. Real GDP, household consumption and gross fixed capital formation (GFCF) exceeded the pre-pandemic levels of 2019 by 2-3 percentage points (pp), while unemployment receded to 2018 levels. By contrast, real exports did not recover fully, largely on account of the OPEC+ oil production quotas, which were relaxed only gradually. However, in value terms, merchandise exports soared by nearly 50% on the back of strongly rising energy prices; the current account surplus climbed to 6.9% of GDP; and the government budget moved back into surplus. High-frequency data suggest that the strong growth momentum continued unabated in the first two months of 2022. Industrial production was up 8.6% in January and 6.3% in February (year on year), whereas retail sales expanded by 3.6% and 5.9%, respectively. On a negative note, inflationary pressures picked up markedly as well: by February, consumer price inflation had climbed to 9.2% on an annual basis. This was not confined to food and energy, but was largely broad-based, suggesting some degree of overheating of the economy.

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The Western sanctions in response to the Russian invasion of Ukraine have put an end to this recovery. The sanctions imposed have been quite unprecedented in terms of their scope and the speed with which they have been implemented. They have been coordinated between the EU and other Western countries, notably the US and the UK, and a number of East Asian countries have joined at least some of them. From the economic point of view, the most painful measures have arguably been the freezing of the Central Bank of Russia's (CBR) assets held in Western jurisdictions; the blocking sanctions against some of the biggest Russian banks and their removal from the SWIFT payment system; and the wide-ranging export bans on high-tech products, such as semiconductors, machinery and transport equipment, parts and components for the aviation industry, telecom and IT security devices, sensors, laser equipment, and jet and marine engines. The US and the UK have also imposed an import embargo on Russian energy, while the EU has banned the import of Russian coal, steel and timber, with the possibility of an oil embargo under discussion at the time of writing. Besides, Russia's most-favoured-nation status in trade has been revoked by certain Western countries, and some of them have imposed a 35% tariff on imports from Russia. On top of that, many Western and East Asian companies have stopped exporting to Russia and/or have announced their withdrawal from the country.[38] Russia has retaliated, inter alia, by discriminating against foreign-based entities and individuals from 'unfriendly' jurisdictions in financial transactions, and by preparing legislation on the 'external management' of the assets of some of the companies that are leaving Russia.

The central bank has resorted to wide-ranging capital controls and sharp monetary tightening. Russia was reasonably well prepared for at least some of the sanctions. For instance, since 2014 it has been developing its own payment system, SPFS, which can take the place of SWIFT in domestic and at least some cross-border payments. However, the freezing of nearly half of its foreign reserves (USD 300bn out of USD 643bn) came as a shock and has reduced the scope for foreign exchange interventions. In these circumstances, the CBR had little choice but to resort to capital controls. These have included, inter alia, restrictions on the purchase of foreign currency and its withdrawal from FOREX-denominated accounts; caps on money transfers abroad; and the opportunity for domestic borrowers to service FOREX-denominated debts in roubles. Besides, the policy rate has been hiked to 20% (from 9.5%), and an 80% surrender requirement on the proceeds from exports has been introduced. Also, the CBR has softened the regulatory requirements on banks, making it possible for them to book assets on their balance sheets at pre-war valuations.

These measures, in combination with high energy revenues, have prevented a run on the banks and have helped restore financial stability. The liquidity of the banking sector, which dried up initially, has now been restored, and the financial markets have gradually reopened (albeit with heavy restrictions). Probably the most visible sign of financial stabilisation has been the recovery of the rouble, which, having lost nearly half of its value in the first few weeks of the war, has rallied to the pre-war levels of 75-80 RUB/USD at the time of writing. Although remarkable, this recovery may not be as telling as it first appears, given that it comes on the back of pervasive capital controls and thin trading volumes; nevertheless, a strong rouble – if sustained over the coming months – will help contain inflation via import prices (even if it is unable to offset the negative impact of trade sanctions reducing the supply of imports). These achievements allowed the CBR to relax some of its policies from 8 April: this has included a certain liberalisation of capital controls and a reduction in the policy rate to 17%.

38 At the time of writing, around 600 Western companies have announced their withdrawal or suspended their operations in Russia, and a further 200 or more have deferred further investment or scaled back operations.

By contrast, the fiscal response to the unfolding crisis has so far been very modest. The government is largely using support mechanisms similar to those introduced during the COVID-19 pandemic: regulatory easing, subsidies for small and medium-sized businesses, financial support for low-income families and pensioners, and credit lines to regional budgets. However, the stimulus package announced so far is much smaller and amounts to only 2.4% of GDP at the time of writing.[39] Pensions and public-sector wages were raised by 8.6% from April, but this is still much less than the inflation recorded in just the first three months of 2022 (9.9%), making further upgrades to the government package highly likely. But probably more importantly, demand-side measures are not very well suited to addressing the root causes of the unfolding crisis, which are largely supply-side in nature. For instance, they cannot fix the disruptions to cross-border value chains arising from the Western trade sanctions and the withdrawal of foreign firms.

The impact of sanctions on the real economy has so far been relatively modest and largely confined to a sharp acceleration in inflation. In March alone, consumer prices jumped by 7.6%, bringing inflation to 16.7% on an annual basis. Unlike in previous months, this time around it was the prices of non-food products that were the main driver of inflation (+20.3% on an annual basis), although food prices also picked up markedly (by 18%). The short-lived rouble depreciation was only one factor in the sharp acceleration in inflation. Another, more durable, factor has been the trade sanctions. On the one hand, the export bans and voluntary export restrictions by Western companies have affected the import of final goods into Russia, such as cars and consumer electronics, and have encouraged stockpiling. On the other hand, they have reduced the supply of imported intermediates, thereby undermining domestic production. The more limited choice of suppliers has increased the market power of those that remain (including those from China), resulting in higher prices and deadweight welfare costs. A similar effect can be observed in air travel. After Western countries and Russia closed their airspace to each other and Russian airlines stopped flying to non-Western destinations to avoid the impounding of planes leased from abroad, the price of air tickets soared, doubling in some instances.

However, the full effect of Western sanctions has yet to unfold and will be increasingly felt in the months to come. One indication of this is the recent sharp downturn in business sentiment. The S&P Services Purchasing Managers' Index (PMI) plunged from 52.1 in February to 38.1 in March.[40] The Manufacturing PMI recorded a much smaller decline (from 48.6 to 44.1), but that was still the steepest fall since May 2020. With the full effect of trade sanctions yet to unfold, supply shortages and higher prices will be felt for an increasing range of products – even if the one-off spike observed in March is unlikely to be repeated. For the whole year, consumer prices may pick up on average by around 20%, eating into real incomes. With the imminent laying off of at least some of the labour force previously employed by Western companies, unemployment will rise, too, probably reaching 7-8% this year on an annual average basis. The sharp rise in borrowing costs following monetary policy tightening will kill off the demand for credit, which has been an important driver of domestic demand up until now. Exports will suffer on account of both Western import bans and Russia's own export restrictions (such as on wheat). However, with imports falling even more, real net exports will contribute positively to GDP growth this year.

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39 For more details on the package announced, see 'Russia's invasion of Ukraine: Assessment of the humanitarian, economic and financial impact in the short and medium term', wiiw Policy Note No. 59, April 2022, p. 29.

40 A reading of above 50 indicates an expansion compared to the previous month; below 50 represents a contraction.

All in all, the economy will slide into deep recession this year, while 2023 may post another GDP contraction. In the baseline scenario, which crucially assumes no major further strengthening of Western sanctions, and above all no EU embargo on Russian oil and gas, we project real GDP to shrink by 9% this year. Unlike during the financial crises of 1998 and 2008-2009, which both witnessed sharp economic downturns followed by swift recoveries, a V-shaped recovery is unlikely this time around. With many of the sanctions likely to stay in place (barring a change in Russia's political regime, which still appears unlikely), the economic dynamics this year and thereafter will be rather L-shaped. In addition, the still strong showing of the economy in the first quarter of 2022 may create a high base effect, resulting in another, albeit shallower, recession next year.

Russia's long-term growth potential has been undermined as well. As things stand now, Russia will be largely cut off from the opportunity to import technology and high-tech goods from top producers and leaders in the advanced industries. Increased trade and investment cooperation with China (and other countries in Asia and Latin America) will provide some relief, but will hardly compensate fully for the disruption of Russia's economic ties with the West. Reduced access to advanced technologies means that the country will likely remain stuck with the parameters that have constrained its economic growth over the past decade: low levels of investment,[41] together with its generally low productivity. For these reasons, Russia's long-term growth is likely to remain below the global average, resulting in its increasing backwardness compared to the rest of the world. To make matters worse, Russia may lose part of its energy revenues because of the EU's plans to reduce dependence on Russian energy. With an ensuing switch to external (and fiscal) deficits and constraints on external borrowing, the Russian economy may become vulnerable to any future external shocks.

[41] The share of GFCF in Russian GDP in 2010-2020 averaged a mere 21.4%, which is too low to ensure sustainable catching-up with advanced economies.

Table 4.18 / Russia: Selected economic indicators

	2018	2019	2020	2021 [1]	2022	2023 Forecast	2024
Population, th pers., average	146,831	146,765	146,460	145,825	145,000	144,800	144,700
Gross domestic product, RUB bn, nom.	103,862	109,608	107,315	130,795	148,800	165,700	174,900
annual change in % (real)	2.8	2.2	-2.7	4.7	-9.0	-1.5	1.0
GDP/capita (EUR at PPP)	19,450	19,920	18,920	22,450	.	.	.
Consumption of households, RUB bn, nom.	51,884	56,110	54,120	64,785	.	.	.
annual change in % (real)	4.3	3.8	-7.3	9.6	-10.0	-2.0	1.5
Gross fixed capital form., RUB bn, nom.	21,452	22,911	23,120	26,110	.	.	.
annual change in % (real)	0.6	1.0	-4.4	7.0	-18.0	-5.0	3.0
Gross industrial production [2]							
annual change in % (real)	3.5	3.4	-2.1	5.3	-12.0	2.0	2.5
Gross agricultural production							
annual change in % (real)	-0.2	4.3	1.3	-0.9	.	.	.
Construction output							
annual change in % (real)	6.3	2.1	0.7	6.0	.	.	.
Employed persons, LFS, th, average	72,532	71,933	70,601	71,700	69,550	69,900	70,600
annual change in %	0.3	-0.8	-1.9	1.6	-3.0	0.5	1.0
Unemployed persons, LFS, th, average	3,658	3,465	4,321	3,600	5,200	4,900	4,600
Unemployment rate, LFS, in %, average	4.8	4.6	5.8	4.8	7.5	7.0	6.5
Reg. unemployment rate, in %, eop [3]	0.9	0.9	3.7	1.0	.	.	.
Average monthly gross wages, RUB	43,724	47,867	51,344	56,545	62,400	71,800	76,900
annual change in % (real, gross)	8.5	4.8	3.8	2.9	-8.0	1.0	3.0
Consumer prices, % p.a.	2.9	4.5	3.4	6.7	20.0	14.0	4.0
Producer prices in industry, % p.a. [4]	12.1	2.0	-3.8	24.5	30.0	10.0	5.0
General governm. budget, nat. def., % of GDP							
Revenues	35.9	36.0	35.6	36.8	36.5	37.0	36.5
Expenditures	33.0	34.1	39.6	36.0	39.5	37.0	35.5
Deficit (-) / surplus (+)	2.9	1.9	-4.0	0.8	-3.0	0.0	1.0
General gov. gross debt, nat. def., % of GDP	12.1	12.4	17.6	16.0	17.0	15.0	13.0
Stock of loans of non-fin. private sector, % p.a.	13.9	6.5	12.4	19.8	.	.	.
Non-performing loans (NPL), in %, eop [5]	5.3	6.0	6.1	5.1	.	.	.
Central bank policy rate, % p.a., eop [6]	7.75	6.25	4.25	8.50	14.00	9.00	6.00
Current account, EUR m [7]	98,142	58,518	31,533	103,080	161,000	113,000	102,100
Current account, % of GDP	7.0	3.9	2.4	6.9	10.8	7.5	7.0
Exports of goods, BOP, EUR m [7]	376,612	374,738	291,760	417,102	418,900	370,700	370,700
annual change in %	20.5	-0.5	-22.1	43.0	0.4	-11.5	0.0
Imports of goods, BOP, EUR m [7]	211,127	226,668	209,726	256,766	203,600	204,600	214,800
annual change in %	0.0	7.4	-7.5	22.4	-20.7	0.5	5.0
Exports of services, BOP, EUR m [7]	54,845	55,275	42,080	47,259	45,000	47,200	49,600
annual change in %	7.6	0.8	-23.9	12.3	-4.8	4.9	5.1
Imports of services, BOP, EUR m [7]	80,366	87,954	56,448	63,750	57,300	60,100	63,200
annual change in %	2.1	9.4	-35.8	12.9	-10.1	4.9	5.2
FDI liabilities, EUR m [7]	7,453	28,548	8,296	33,639	.	.	.
FDI assets, EUR m [7]	26,620	19,574	5,117	55,061	.	.	.
Gross reserves of CB excl. gold, EUR m [7)8]	333,617	396,378	372,318	439,693	.	.	.
Gross external debt, EUR m [7]	397,860	438,645	380,540	424,145	476,200	451,900	422,700
Gross external debt, % of GDP	28.3	29.0	29.2	28.3	32.0	30.0	29.0
Average exchange rate RUB/EUR	73.87	72.51	82.39	87.20	100.0	110.0	120.0

Note: Including Crimean Federal District.

1) Preliminary and wiiw estimates. - 2) Excluding small enterprises. - 3) In % of labour force (LFS). - 4) Domestic output prices. - 5) According to Russian Accounting Standards overdue debt is defined as debt service overdue, therefore the data are not fully comparable with other countries. - 6) One-week repo rate. - 7) Converted from USD. - 8) Including part of resources of the National Wealth Fund of the Russian Federation.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.