RUSSIA: Resilience to sanctions accompanied by structural change

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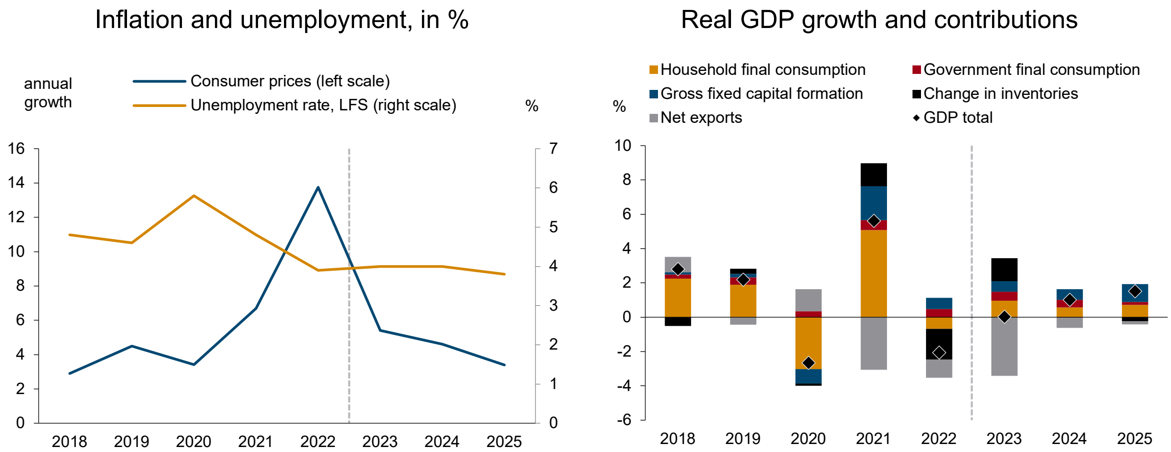
After a sharp downturn in Q2 2022, the economy stabilised in the second half of the year and is projected to broadly stagnate in 2023. The overall picture masks the very uneven impact of the war and the sanctions across sectors: while domestic trade and industries that depend heavily on cross-border linkages have suffered, military production and certain import-substituting sectors have flourished. The recently imposed energy sanctions have dealt government revenue a heavy blow and will contribute to budget deficits being much higher in the years ahead.

Figure 5.18 / Russia: Main macroeconomic indicators



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

After falling sharply in Q2 2022, the economy stabilised in the second half of the year. Since its invasion of Ukraine, Russia has become the most sanctioned country globally. At the time of writing, some 14,000 sanctions are in place against Russia, including a wide range of financial, trade and personal sanctions; moreover, many foreign companies have announced their withdrawal from the country. As a result, in Q2 2022 real GDP plunged by 4.6% in quarterly (seasonally adjusted) terms, on account of falling private consumption and the depletion of inventories. However, in both Q3 and Q4 it recovered by 0.5%, helped in part by the replenishment of inventories (in Q3) and by the big increase in public consumption (in Q4). Besides, the development of gross fixed capital formation remained positive throughout, with public-sector investments gaining momentum and many private companies rushing to complete unfinished projects in the face of increased uncertainty. On an annual basis, real GDP growth improved (i.e. became less negative) from quarter to quarter; and for 2022 as a whole it shrank by a mere 2.1%.

The overall GDP picture masks the very uneven impact of the war and the sanctions across sectors. By far the worst performance last year came from wholesale and retail trade (-12.7% in value-added terms), on account of faltering consumer demand and the reduced availability of Western products; meanwhile, manufacturing value added shrank by only 2.5%. Within manufacturing, two types of industry were worst affected: (i) some export-oriented industries that were directly subject to Western sanctions and/or Russia's own restrictions, such as wood and basic chemicals (whose output in 2022 fell by 12.5% and 5.4%, respectively); and (ii) industries serving predominantly the domestic market that were largely foreign owned and/or heavily dependent on imported parts and components, most notably the production of motor vehicles and domestic appliances (-44.5% and -40.2%, respectively). On the other hand, military production appears to have flourished (e.g. the production of 'fabricated metal products not classified elsewhere', which includes weapons and ammunition, rose by 14.2% last year), as do some import-substituting industries, such as pharmaceuticals (+26.5%) and the production of electric motors, generators and transformers, etc. (+7.9%). Other sectors that recorded solid value-added growth last year were agriculture (+6.7%), construction (+5.2%), hotels and catering (+4.3%), public administration and security (+4.1%) and the financial sector (+3.4%). Agriculture benefited from an exceptionally good harvest; construction and the banking sector profited from the subsidised mortgage programme; and domestic tourism experienced a boom thanks to the sharply reduced opportunities open to Russians to travel abroad.

Part of the resilience can also be attributed to the many loopholes and exemptions from the sanctions regime. Some of Russia's important export products (such as food, fertilisers, natural gas and non-ferrous metals) have not been sanctioned, and the country reportedly continues to receive many sanctioned Western goods via third countries – although they have become more expensive as a result.[21] Besides, contrary to earlier announcements, only about 6% of foreign companies have so far withdrawn completely from Russia, while another 38% are in the process of leaving, and 16% have reduced their current operations and are holding off on new investments.[22] The subsidiaries of Western banks that continue to operate in Russia are exempt from sanctions and are an important vehicle for cross-border payments. Apart from unfavourable market conditions, there are also legal obstacles to any withdrawal. The sale of Russian assets by investors from 'unfriendly' countries (i.e. countries that have imposed sanctions) is subject to approval by a government sub-commission, which now requires at least a 50% price discount on the independent market valuation and a 5-10% 'exit tax' to be paid to the Russian budget. The exit of 'unfriendly' investors from the financial, fuel and energy sectors is prohibited altogether, unless explicitly authorised by the president.

However, the newly imposed energy sanctions have dealt the Russian budget a heavy blow. On 5 December 2022, the EU and the G-7 placed an import embargo on Russian oil and a price cap of USD 60 per barrel on oil shipments to third countries; these measures were supplemented on 5 February 2023 by similar restrictions on oil products. As a consequence, the price of Russian oil (Urals) plunged sharply, to around USD 50 per barrel. Because of this and the sharply reduced gas exports, the federal government's revenue from energy plummeted by 45% and total revenue by 21% in Q1 2023, while

21 In order to prevent this, the US recently stepped up pressure on neutral countries, resulting inter alia in Turkey temporarily halting the transit of sanctioned Western products to Russia (it was partly resumed several weeks later) and Kazakhstan introducing an electronic tracking system of cargo shipments across the country.

22 For more on that, see V. Astrov, 'Chart of the month: Very few firms have left Russia since its invasion of Ukraine', wiiw Monthly Report No. 3, March 2023, pp 7-8.

expenditure soared by 34% (all in nominal terms, year on year).[23] As a result, Q1 2023 closed with a federal budget deficit of RUB 2.4 trillion, or 82% of the target for the *whole* year. The dismal tax collection so far this year has already prompted corrective measures. As of April, taxation of the energy sector will be based not, as before, on the price of Urals (which has become largely irrelevant, given that the bulk of Russian oil has been diverted to Asia, where prices are higher), but on the discounted Brent price, with the size of the applied discount declining progressively over time. Another measure currently under discussion is a one-off 'windfall' tax on profits (defined as the difference between profits earned in 2021-2022 and 2018-2019), which would be levied in Q4 2023 on all companies, except those in the energy sector and small and medium-sized businesses. According to the government, these two measures should bring in 0.4% and 0.2% of GDP, respectively, in additional revenue.

Recent high-frequency indicators suggest further overall economic stabilisation. According to estimates by the Ministry of Economy, after -4.2% in December 2022, the annual rate of GDP decline improved to -3.2% in January 2023 and -3.1% in February, largely on account of improved industrial performance (-4.3%, -2.4% and -1.7%, respectively) – although, on a monthly seasonally adjusted basis, industrial output has been essentially stable since the sharp downturn in April 2022. Business sentiment has been generally improving as well. The S&P Global Purchasing Managers' Index (PMI) has been rising – thanks to the markedly improved PMI in services – and reached 53 in February 2023 (50 separates expansion from contraction), thereby exceeding pre-war levels. The main drag on economic activity continues to be private consumption: according to the Ministry of Economy, the combined turnover of retail trade, catering and household services was down 3.6%, year on year, in January 2023 and 4.4% in February. Depressed private consumption stands in sharp contrast to the trend in real wages, which has been positive since October 2022.

The economy is heading for stagnation this year, to be followed by sluggish recovery in 2024-2025. With the current trends, GDP growth will likely turn positive on an annual basis starting from Q2 2023 (thanks to the low base effect) and will be close to zero for the year as a whole, with the recovering domestic demand offset by falling net (especially energy) exports. Until recently, Russian oil production was holding up well; however, it was cut by some 5% in March and will remain at the same level until the end of the year (as part of the OPEC+ production cuts). The gas sector is facing even bigger problems. Since mid-2022, Russia has been reining in its gas exports to Europe, ostensibly for political reasons. As a result, last year pipeline exports of Russian gas to Europe plunged by 55%, and overall gas exports by 31%, translating into a 12% reduction in gas production. These trends have carried over into 2023, with gas production falling by 13.5% (year on year) in the first two months and the International Energy Agency predicting a drop of 8% for the year as a whole. Unlike oil, gas exports are much more difficult to redirect geographically, given the absence (for the time being) of pipelines connecting Western Siberia and Asia, while production and exports of liquefied natural gas (LNG) could be hampered by Western restrictions on the exports of LNG technology to Russia.

Long-term prospects will depend largely on the success of forthcoming structural change. Because of the energy sanctions and economic decoupling from the West more generally, the weight of the energy sector in Russia's economy will most probably decline in the years ahead. However, successful economic diversification, which would be conducive to sustainable growth, would require the creation of modern and internationally competitive production capacities in fields other than energy and other raw materials – which may not be easy because of the sanctions and the withdrawal of many

[23] According to some estimates, nearly half of all federal spending in Q1 2023 went on defence and security.

Western firms. The key questions here are: (i) to what extent Western equipment, parts and components can be replaced through domestic production and/or increased imports from China and other 'friendly' countries; and (ii) whether this will be enough for the modernisation. The process of substitution is far from complete, but available surveys of Russian firms that previously relied on Western inputs suggest that (especially) Chinese products have already proved crucial.[24] Having said that, both Chinese and Russian-made products are generally of inferior quality, and some Western products (such as advanced semiconductor chips) reportedly cannot be replaced at all. It is therefore highly likely that diversification of the Russian economy will be accompanied by its 'primitivisation', in line with 'technologically regressive import substitution'.[25]

24 One such survey suggests that last year, 52% of firms started importing Chinese intermediate inputs and components and 67% Chinese production equipment, while the role of 'import substitution' through domestic production was generally less pronounced, https://www.rbc.ru/economics/02/02/2023/63da2eda9a7947dc8601f42a.

25 This term has been coined by Branko Milanovic, who argues that the challenges currently facing Russia are unique and quite unlike anything faced by Brazil or Turkey, for example, which in the past also pursued import-substitution policies· https://www.globalpolicyjournal.com/blog/18/05/2022/novelty-technologically-regressive-import-substitution

Table 5.18 / Russia: Selected economic indicators

	2019	2020	2021	2022 1)	2023	2024	2025
						Forecast	
Population, th pers., average 2)	146,765	146,460	145,864	146,702	144,800	144,200	143,800
Gross domestic product, RUB bn, nom.	109,608	107,658	135,295	153,435	159,600	168,500	178,800
annual change in % (real)	2.2	-2.7	5.6	-2.1	0.0	1.0	1.5
GDP/capita (EUR at PPP)	19,840	19,660	22,580	22,460	.	.	.
Consumption of households, RUB bn, nom.	56,110	54,752	65,811	73,260	.	.	.
annual change in % (real)	3.8	-5.9	10.0	-1.4	2.0	1.2	1.5
Gross fixed capital form., RUB bn, nom.	22,911	23,211	26,623	31,784	.	.	.
annual change in % (real)	1.0	-4.0	9.1	3.3	3.0	3.0	5.0
Gross industrial production 3)							
annual change in % (real)	3.4	-2.1	6.4	-0.6	-3.0	2.5	3.0
Gross agricultural production							
annual change in % (real)	4.3	1.3	-0.4	10.2	.	.	.
Construction output							
annual change in % (real)	2.1	2.1	7.0	5.2	.	.	.
Employed persons, LFS, th, average	71,933	70,601	71,719	72,000	72,000	72,360	73,080
annual change in %	-0.8	-1.9	1.6	0.4	0.0	0.5	1.0
Unemployed persons, LFS, th, average	3,465	4,321	3,631	3,000	2,900	2,900	2,800
Unemployment rate, LFS, in %, average	4.6	5.8	4.8	3.9	4.0	4.0	3.8
Reg. unemployment rate, in %, eop 4)	0.9	3.7	1.0	0.8	.	.	.
Average monthly gross wages, RUB	47,867	51,344	57,244	64,460	68,600	73,500	77,900
annual change in % (real, gross)	4.8	3.8	4.5	-1.0	1.0	2.5	2.5
Consumer prices, % p.a.	4.5	3.4	6.7	13.8	5.4	4.6	3.4
Producer prices in industry, % p.a. 5)	2.0	-3.8	24.5	11.4	2.0	5.0	5.0
General governm. budget, nat. def., % of GDP							
Revenues	36.0	35.5	35.6	34.6	35.0	35.0	35.0
Expenditures	34.1	39.5	34.8	36.0	39.0	38.5	38.0
Deficit (-) / surplus (+)	1.9	-4.0	0.8	-1.4	-4.0	-3.5	-3.0
General gov. gross debt, nat. def., % of GDP	12.4	17.6	15.5	14.9	18.0	20.0	22.0
Stock of loans of non-fin. private sector, % p.a.	6.5	12.4	19.8	13.6	.	.	.
Non-performing loans (NPL), in %, eop 6)	6.0	6.1	5.1	4.7	.	.	.
Central bank policy rate, % p.a., eop 7)	6.25	4.25	8.50	7.50	7.50	6.50	6.00
Current account, EUR m 8)	58,614	30,957	103,268	220,176	91,300	68,300	53,000
Current account, % of GDP	3.9	2.4	6.7	10.4	4.3	3.4	2.7
Exports of goods, BOP, EUR m 8)	374,738	291,895	417,548	555,903	424,900	416,400	416,400
annual change in %	-0.5	-22.1	43.0	33.1	-23.6	-2.0	0.0
Imports of goods, BOP, EUR m 8)	226,668	210,118	256,781	264,900	272,600	286,200	300,500
annual change in %	7.4	-7.3	22.2	3.2	2.9	5.0	5.0
Exports of services, BOP, EUR m 8)	55,335	41,973	47,047	45,840	44,900	47,200	49,500
annual change in %	0.9	-24.1	12.1	-2.6	-2.1	5.1	4.9
Imports of services, BOP, EUR m 8)	87,918	56,666	64,137	66,817	64,200	67,400	70,700
annual change in %	9.4	-35.5	13.2	4.2	-3.9	5.0	4.9
FDI liabilities, EUR m 8)	28,548	8,296	34,166	-40,756	.	.	.
FDI assets, EUR m 8)	19,574	5,117	55,647	-13,271	.	.	.
Gross reserves of CB excl. gold, EUR m 8)9)	396,378	372,318	439,693	414,569	.	.	.
Gross external debt, EUR m 8)	438,757	380,941	426,259	353,797	319,200	277,500	258,300
Gross external debt, % of GDP	29.0	29.2	27.5	16.7	15.0	14.0	13.0
Average exchange rate RUB/EUR	72.51	82.39	87.20	72.48	75.0	85.0	90.0

Note: Including Crimean Federal District.

1) Preliminary and wiiw estimate. - 2) From 2022 according to census 2021. - 3) Excluding small enterprises. - 4) In % of labour force (LFS). - 5) Domestic output prices. - 6) According to Russian Accounting Standards overdue debt is defined as debt service overdue, therefore the data are not fully comparable with other countries. - 7) One-week repo rate. - 8) Converted from USD. - 9) Including part of resources of the National Wealth Fund of the Russian Federation.

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