RUSSIA: 'Peak overheating' has likely been reached

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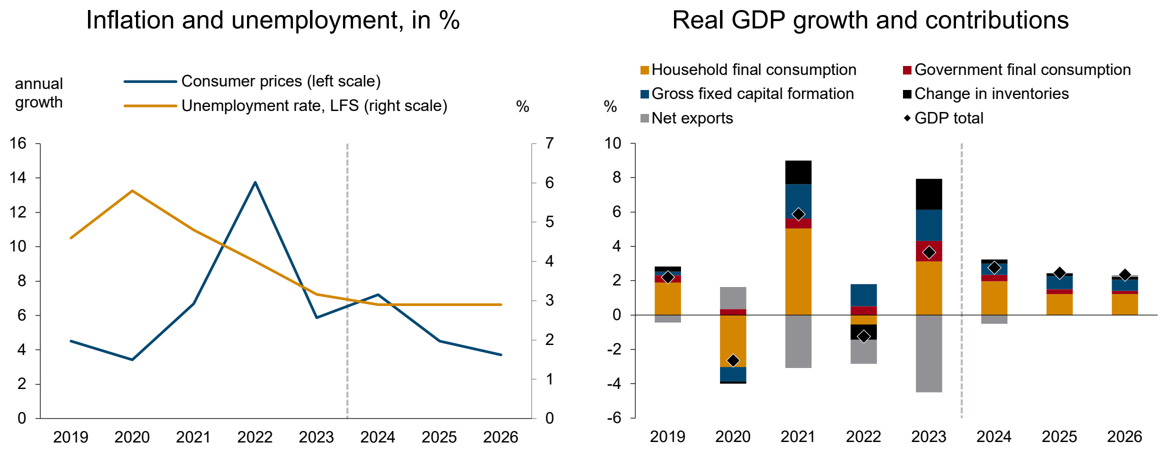
Last year, GDP expanded by 3.6%, thanks largely to the boom in military production, which has had positive effects – both direct and indirect – for most of the rest of the economy. With inflation running in excess of 7% and the unemployment rate plunging to below 3%, the economy has clearly been overheating. However, the recent stabilisation of inflation suggests that 'peak overheating' has already been reached. Growth is projected to slip below 3% in 2024 and beyond, while inflation will gradually return to closer to the 4% target.

Figure 6.18 / Russia: Main macroeconomic indicators



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

In 2023, the Russian economy grew by 3.6% – faster than had generally been expected. Across economic sectors, the highest growth in value added was reported in hospitality and catering (+10%), information and communication technology (+9.8%), the financial sector (+8.7%), administrative and support service activities (+8%) and manufacturing (+6.9%), as well as in construction and trade (+6.6% apiece). Manufacturing industries with a large share of military output recorded above-average growth rates. For instance, value added in computers, electronic and optical products soared by 31.1%; in finished metal products except machinery and equipment – by 26%; in other transport vehicles and equipment – by 22.7%; and in electrical equipment – by 17.4%. The strong performance of many market services went hand in hand with the boom in private consumption (+6.5%), while construction benefited from the solid expansion of gross fixed capital formation (+8.8%). Government consumption grew by 7%, while the contribution of net exports to GDP growth was negative (-4.5 percentage points (pp)). Across the broad economic sectors, value added declined only in mining (-2%) and water supply (-3%).

The decline in mining was due primarily to falling natural gas production (-5.5%),[19] whereas oil production remained virtually stable, as the bulk of shipments to Europe were reoriented towards Asia, particularly China and India.

The boom in private consumption has been fuelled by high wage growth on the back of labour shortages. By February 2024, the unemployment rate (Labour Force Survey) had plunged to an all-time low of 2.8% – not least on account of military mobilisation and the emigration of around 1m people since the beginning of the war, which has led to a reduction in the size of the labour force (though it should also be pointed out that employment rate is also up). Moreover, the sharp wage hikes enacted in the defence sector have led to competition for labour from other sectors. As a result, in 2023 average wages soared by 14.1% in nominal and by 7.8% in real terms, leading to a 1.8 pp rise in the wage share of GDP. Nevertheless, at 40.3%, the latter was still rather low in international terms. This suggests that strong wage growth – and the redistribution of national income from capital to labour – may continue for some years to come without unduly affecting price competitiveness, just so long as rising production costs are (at least partly) absorbed by squeezing profits. In poor regions (which have been the main source of contract soldiers and mobilised reservists for the war), household incomes have also been boosted by hefty government payments to soldiers and their families in the event of serious injury or death. All in all, the real disposable income of households picked up by 5.4% last year, with a marked acceleration to 6.8% year on year in Q4.[20]

Investment growth has been facilitated by military infrastructure projects, by the restructuring of transportation and logistics infrastructure in response to sanctions, and by the reorientation of foreign trade towards Asia, as well as by high business confidence and import substitution in some sectors following the withdrawal of foreign firms. For instance, the domestic market share of imported capital goods (equipment) has fallen from a figure of 80-85% before the war to just about 50% today. Another example is domestic tourism, which has benefited from the stricter visa regulations for Russian citizens in the EU and the huge increase in the cost of flights to Europe. Industries such as automotive production and the production of beverages – which were dominated by foreign owners and experienced a collapse in investment during the first year of the war – have witnessed a sharp rebound in terms of investment as well. However, the capacity of domestic companies to undertake import substitution depends enormously on each particular sector. For instance, despite the ambitious plans (the government intends to build around 1,000 new aircraft by 2030) and generous state funding, the aircraft manufacturing industry is reportedly facing major challenges in expanding its domestic production.

Last year closed with a current account surplus of a mere USD 50bn – less than a quarter of the 2022 value. Relative to GDP, this corresponds to a decline from 10.5% to 2.5%. The main reason for this was the unfavourable trends in foreign trade. In US dollar terms, goods exports fell by 28%, while goods imports, by contrast, picked up by 10%; in services trade, the trends were broadly similar. Exports suffered primarily on account of the much-lower oil prices, not least due to Western energy sanctions: the price discount on Russian oil versus the benchmark Brent widened sharply in Q1 2023, before narrowing gradually over time; but it widened again in Q4, largely because of increased scrutiny from the US as it sought to enforce secondary sanctions on companies from third countries that were found to be violating the USD 60 per barrel price cap. This demonstrates that energy sanctions, when they are supported by

19 In particular, natural gas production by the state-owned Gazprom declined by around 9%, and pipeline gas exports by around a quarter last year – a direct consequence of the sharply curtailed exports to the EU.

20 That said, real disposable household incomes in 2023 were still 1.4% below the all-time peak registered in 2013.

effective enforcement of secondary sanctions, have the potential to seriously undermine Russia's energy (and fiscal) revenues.

Recent high-frequency data suggest a further strengthening of growth momentum. According to Ministry of Economy estimates, real GDP picked up by 4.6% year on year in January and by 7.7% year on year in February. The growth in gross industrial production in those two months reached 4.6% year on year and 8.5% year on year, respectively, while retail trade turnover expanded by 10.7% year on year in the first two months. Apart from the ongoing major rise in household income, private consumption has also been fuelled by a renewed uptick in consumer lending, following a dip at the end of last year in response to sharp monetary policy tightening. So far, the main transmission mechanism of policy tightening has been the strong growth in household deposits, while the response of credit dynamics has been far more muted. On balance, the net saving propensity of households has risen; but this has not been sufficient to offset the positive effect of rapidly rising incomes on private consumption, which has continued to boom. In February, the consumer sentiment index climbed to another all-time high.

After picking up speed throughout most of last year, inflationary pressures have finally stabilised, albeit at a rather high level. By 8 April 2024, annual consumer price inflation had reached 7.8% – far above the 4% inflation target. Apart from the strong wage growth, inflationary pressures last year were fuelled by a pronounced exchange-rate depreciation of around 30% between January and October, mirroring above all the unfavourable trends in foreign trade. In response, on 16 October the authorities imposed a surrender requirement on export proceeds – something that has proved extremely successful in stabilising the foreign exchange market. Parallel to that, the policy interest rate was hiked sharply, by a combined 8.5 pp between July and December 2023, bringing it to 16%. In real terms, the policy rate now exceeds 8%. This is one of the highest levels in Russia's recent history, and yet so far it has had little success in cooling the economy. Nevertheless, given the recent stabilisation of inflation, the central bank reckons that 'peak overheating' will already have been reached in Q2 2024. A gradual cooling of the economy over the remainder of the year will enable progressive disinflation. Inflation is projected to decline to 5-6% by the end of 2024, which should allow a moderate relaxation of monetary policy.

Despite high military spending and a big drop in energy revenue, last year the consolidated budget deficit reached a relatively modest 2.3% of GDP, the bulk of which was financed by tapping the sovereign National Welfare Fund (NWF). The fiscal outlook has improved greatly this year, with the energy and non-energy tax revenues of the federal government in Q1 2024 soaring by 79% and 43% year on year, respectively, far outstripping the 20% rise in expenditure. On current trends, it is unlikely that the government will run out of funds for warfare any time soon. Despite high military spending (which is officially projected to peak at 6% of GDP this year), the budget deficit is expected to remain at below 2% of GDP over the forecast horizon. Government revenues should be helped by the planned fiscal reforms – a more progressive taxation of personal income and a hike in corporate income tax[21] – as well as by the ambitious privatisation plans (not least involving the sale of the nationalised assets of foreign companies). With the liquid part of the NWF (which can be used to cover budget deficits) now standing at a mere 3.3% of GDP, that may be depleted as early as the end of next year. However, the government will still have the option to borrow from domestic banks: at 15% of GDP, Russia's public debt is still very low. However, the yields on government bonds have risen recently to

[21] The government draft proposal reportedly envisages the introduction of progressive income taxation, with tax rates ranging from 13% to 20% (instead of 13-15% currently), as well as a hike in the corporate tax rate from 20% to 25%.

more than 14% p.a. on ten-year maturity bonds at the beginning of April (although this is still below the policy rate of the central bank).

Economic recovery is expected gradually to run out steam, with growth declining to below 3% this year and approaching 2% by the end of the forecast horizon. Despite a strong start to 2024, tight monetary conditions and the high statistical basis will increasingly weigh on the economic dynamics across the remainder of the year, resulting in GDP growth slowing to 2.8% for the year as a whole and slipping further in 2025 and 2026. Overall, the current growth path of the economy could be sustained over a prolonged period. Against this backdrop, the question is not so much how long the economy can continue to support the war, but rather what will happen when the war is over. The economy has now become accustomed to the war-related fiscal stimulus and could face a demand-side shock once armaments are no longer needed to the same extent.

The main risk to the forecast is on the downside and is related to the impact of secondary sanctions on third countries trading with Russia. For instance, the recently increased US pressure has resulted in several Turkish banks refusing to accept import payments from Russia; this has meant Turkish exports to Russia plunging by around a third year on year in the first two months of 2024. Problems with payments to Chinese banks have recently been mounting as well; even payments in Chinese yuan – widely believed to be sanction-proof – have reportedly been affected. Should these problems persist, the Russian economy may be essentially cut off from the imports of critical parts and components that it needs to sustain domestic (including military) production, resulting in GDP growth being much lower than forecast in the baseline scenario.

Table 6.18 / Russia: Selected economic indicators

	2020	2021	2022	2023 1)	2024	2025 Forecast	2026
Population, th pers., average 2)	146,460	145,864	146,714	146,326	145,800	145,400	145,000
Gross domestic product, RUB bn, nom.	107,658	135,774	155,189	172,148	189,300	203,700	216,800
annual change in % (real)	-2.7	5.9	-1.2	3.6	2.8	2.5	2.3
GDP/capita (EUR at PPP)	19,660	22,180	23,220	24,550	.	.	.
Consumption of households, RUB bn, nom.	54,752	67,029	74,453	84,724	.	.	.
annual change in % (real)	-5.9	9.9	-1.1	6.5	4.0	2.5	2.5
Gross fixed capital form., RUB bn, nom.	23,211	26,073	31,661	37,636	.	.	.
annual change in % (real)	-4.0	9.3	6.7	8.8	3.0	3.5	3.0
Gross industrial production 3)							
annual change in % (real)	-2.1	6.3	0.7	3.5	2.5	2.0	1.7
Gross agricultural production							
annual change in % (real)	1.3	-0.7	11.3	-0.3	.	.	.
Construction output							
annual change in % (real)	2.1	7.0	7.5	7.9	.	.	.
Employed persons, LFS, th, average 2)	70,601	71,719	72,644	73,636	74,370	74,740	74,740
annual change in %	-1.9	1.6	0.5	1.4	1.0	0.5	0.0
Unemployed persons, LFS, th, average 2)	4,321	3,631	2,988	2,401	2,200	2,200	2,200
Unemployment rate, LFS, in %, average 2)	5.8	4.8	4.0	3.2	2.9	2.9	2.9
Reg. unemployment rate, in %, eop 2)4)	3.7	1.0	0.8	0.6	.	.	.
Average monthly gross wages, RUB	51,344	57,244	65,338	74,550	83,900	91,200	97,900
annual change in % (real, gross)	3.8	4.5	0.3	7.8	5.0	4.0	3.5
Consumer prices, % p.a.	3.4	6.7	13.8	5.9	7.2	4.5	3.7
Producer prices in industry, % p.a. 5)	-3.8	24.5	11.4	4.0	10.0	5.0	4.0
General governm. budget, nat. def., % of GDP							
Revenues	35.5	35.4	34.2	34.3	35.0	35.5	35.5
Expenditures	39.5	34.7	35.6	36.6	36.7	37.0	36.5
Deficit (-) / surplus (+)	-4.0	0.8	-1.4	-2.3	-1.7	-1.5	-1.0
General gov. gross debt, nat. def., % of GDP	17.6	15.4	14.7	14.9	15.0	15.5	16.0
Stock of loans of non-fin. private sector, % p.a.	12.4	19.8	13.6	23.2	.	.	.
Non-performing loans (NPL), in %, eop 6)	6.1	5.1	4.7	3.7	.	.	.
Central bank policy rate, % p.a., eop 7)	4.25	8.50	7.50	16.00	13.50	10.00	8.00
Current account, EUR m 8)	30,957	105,540	224,578	46,420	59,100	59,100	59,800
Current account, % of GDP	2.4	6.8	10.5	2.5	3.3	3.2	3.0
Exports of goods, BOP, EUR m 8)	291,895	417,389	559,444	392,085	404,600	412,700	425,100
annual change in %	-22.1	43.0	34.0	-29.9	3.2	2.0	3.0
Imports of goods, BOP, EUR m 8)	210,118	254,276	261,270	280,320	286,400	295,000	306,800
annual change in %	-7.3	21.0	2.8	7.3	2.2	3.0	4.0
Exports of services, BOP, EUR m 8)	41,973	46,924	45,952	38,087	38,200	38,900	40,100
annual change in %	-24.1	11.8	-2.1	-17.1	0.3	1.8	3.1
Imports of services, BOP, EUR m 8)	56,666	64,088	66,968	69,611	73,200	76,200	79,200
annual change in %	-35.5	13.1	4.5	3.9	5.2	4.1	3.9
FDI liabilities, EUR m 8)	8,296	34,166	-37,607	-10,333	.	.	.
FDI assets, EUR m 8)	5,117	55,647	-12,365	8,842	.	.	.
Gross reserves of CB excl. gold, EUR m 8)9)	372,318	439,693	414,569	400,316	.	.	.
Gross external debt, EUR m 8)	380,941	431,614	358,013	286,490	252,400	250,000	256,200
Gross external debt, % of GDP	29.2	27.7	16.7	15.3	14.0	13.5	13.0
Average exchange rate RUB/EUR	82.39	87.20	72.48	92.14	105.0	110.0	110.0

Note: Including Crimean Federal District.

1) Preliminary and wiiw estimate. - 2) From 2022 according to census 2020. - 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.