RUSSIA: Resisting depreciation pressures

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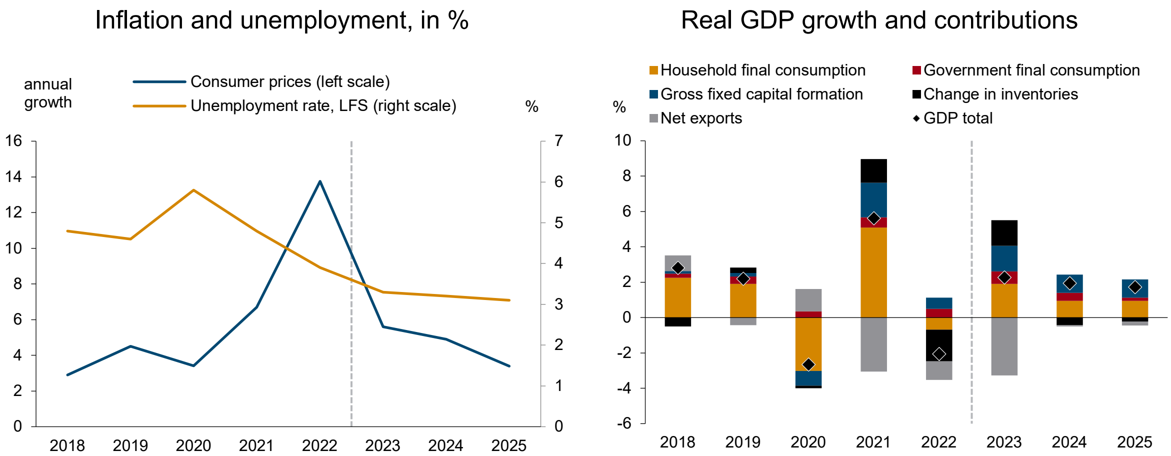
Low oil prices and a strong rebound of imports have resulted in the rouble depreciating by about 30% since the beginning of the year, prompting drastic monetary policy tightening. Nevertheless, the economy is continuing to recover on the strength of domestic demand, with military procurement boosting industrial production and construction, and a tight labour market pushing up wages and consumption. This year, growth is projected to exceed 2%, to be followed by a mild deceleration in 2024-2025. A growing addiction to fiscal military stimulus and increased technological backwardness together increase the risk of stagnation (or even outright crisis) once the war is over.

Figure 6.18 / Russia: Main macroeconomic indicators



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

The Russian economy is continuing its recovery from last year's slump, thanks in large part to the heavy military spending. In Q2 2023, real GDP grew by 4.9% year on year, bringing growth in the first half year to 1.6%. This means that the economic crisis has now essentially been left behind, at least at the aggregate level (which masks great heterogeneity across sectors and industries). Industrial production growth in H1 2023 averaged 2.6%, with those industries that enjoy a large share of military production leading the way. Accordingly, the production of computers, electronic and optical products soared by 30.4%; 'finished metal products except machinery and equipment' by 29.7%; other transport vehicles and equipment by 22.1%; and electric equipment by 22%. Crucially, the military production boom is being assisted by the fact that Russia reportedly imports most of the products it requires, including badly needed semiconductor chips, via third countries – the Western trade sanctions notwithstanding. Other sectors that recorded above-average growth included construction (9.8%) and hospitality and catering (12.3%, both in value-added terms). Construction benefited in large part from the creation of military infrastructure in regions bordering Ukraine, as well as of transport and logistics infrastructure in the Far East, along the Trans-Siberian Railway (in the wake of the foreign trade reorientation towards Asia); meanwhile, the upsurge in hospitality and catering partly reflects the boom in domestic tourism, since travelling abroad has become so much more difficult.[27] By contrast, mining value added declined by 2.1%, largely reflecting the 14.9% drop in natural gas production.

On a negative note, the exchange rate has depreciated by around 30% since the beginning of the year, mirroring the unfavourable trends in foreign trade. Whereas last year the rouble was supported by high energy prices and the initial collapse of imports (in the face of Western trade sanctions and the withdrawal of many foreign companies), in 2023 those trends have largely gone into reverse. Global oil prices have generally declined; moreover, the price spread between Brent and the Russian oil widened (at least initially) following the imposition of the EU import embargo (in December 2022 for crude oil and in February 2023 for oil products), although Russia then successfully reoriented the bulk of its oil exports to Asia.[28] (It was not until July 2023 that oil prices started to rise again, in large part due to voluntary production cuts by Russia and Saudi Arabia, while the Brent-Urals spread has narrowed recently.)[29] Russia's exports of natural gas have also struggled: since the beginning of the war, the country has lost a large slice of its main gas market – the EU – and the limitations of the existing infrastructure mean that it will take some time to reorient exports to Asia. All in all, Russian goods exports declined by 32% in January-August 2023 (in US dollar terms); by contrast, imports surged by 17%, as economic recovery gained momentum and new ways were found to circumvent the trade sanctions. The current account surplus in the first eight months of the year shrank by more than 85% year on year, putting pressure on the exchange rate.

The rouble depreciation has fuelled inflation and prompted drastic monetary policy tightening. After the low of 2.3% in April 2023, consumer price inflation has been on the rise, reaching 4.3% in July and 5.2% in August – thus above the 4% inflation target, and with annualised inflation (based on the most recent trends) even higher. Exchange rate depreciation apart, the steep rise in the price of petrol and diesel fuel following the recent cuts to the subsidies has played a role as well (leading the government to impose a ban on exports of these products as of 21 September). Under these circumstances, the Central Bank of Russia (CBR) has resorted to drastic policy tightening: it has hiked the key rate in three steps since July, by a combined 5.5pp (to 13%) and has stepped up foreign exchange interventions.[30] These measures, coupled with the increased 'voluntary' conversion by exporters of their foreign currency earnings, have been successful in stabilising the exchange rate for now. Such fundamental factors as recovering oil prices should provide support for the rouble in the coming months as well. However, as the pass-through from the previous depreciation into consumer prices is not yet over, inflationary pressures may not subside very rapidly. Besides, the CBR is

27 Direct flights between the EU and Russia were cancelled immediately after the start of the war, and most land borders were effectively closed during the subsequent months as well. Besides, EU visa procedures for Russians have become much more restrictive.

28 China and India now absorb more than half of Russia's oil exports.

29 The price cap, set by the G-7 at USD 60 per barrel for Russian oil shipments to third countries, has arguably played little part (if any) in these developments: the price of Russian oil shipped to Asia, such as ESPO (Eastern Siberia-Pacific Ocean), has invariably been higher than the cap.

30 Another move in this vein has been the tightening, as of September 2023, of regulations on subsidised mortgages, which had been an important driver of credit growth. The minimum downpayment required has been raised from 15% to 20%, and the interest rate subsidy on mortgages has been cut by 0.5pp.

concerned about ‘overheating’ of the economy, whereby strong domestic demand is increasingly facing capacity bottlenecks, with potentially adverse inflationary consequences.

The presence of capacity bottlenecks is suggested by the widespread labour and skill shortages. By July 2023, the unemployment rate (Labour Force Survey) had plunged to a mere 3% – an all-time low. On the one hand, after near-stagnation last year, employment growth has gained momentum, reaching 2.6% year on year in July 2023. On the other hand, labour supply has been shrinking for many years now on account of long-term demographic decline. The ‘partial’ military mobilisation announced in September 2022 (of up to 500,000 men) and the recent emigration (mostly to other CIS countries, Serbia, Israel and Turkey) of some 800,000-900,000 people fleeing mobilisation and the increasingly repressive political regime have only served to aggravate this trend. Even if the real labour market may not be as tight as is suggested by the official statistics,[31] the labour and skill shortages are widespread, especially in the IT sector. The structural mismatch also plays a role: workers laid off in sectors that are affected by sanctions and by the withdrawal of foreign firms often cannot be absorbed by those industries that are booming, such as arms industry. Labour and skills shortages are typically identified as likely to be among the key constraints on Russia’s growth performance in years to come. However, there is a welcome demand-side effect: with employers forced to compete for labour, real wages are being pushed up – in H1 2023, earnings soared by 6.8% to become an important driver of recovering private consumption.

Another manifestation of capacity bottlenecks is the high level of capacity utilisation – something that bodes well for investment. According to various surveys, by mid-2023 capacity utilisation had reached its highest level in Russia’s recent history. Coupled with labour shortages, this suggests that the potential for economic recovery based on idle production capacities may now be largely exhausted. Under these circumstances, the continuation of economic growth will crucially hinge on new (labour-saving) investments and their productivity. Indeed, there is evidence of vibrant investment activity currently under way in Russia: investment was up 7.6% in H1 2023, partly on account of the above-mentioned construction boom, but also in the wake of the realignment of production and logistic value chains by private businesses in response to the recent shocks. However, there are question marks over the productivity of investments, given Russia’s reduced access to Western technology. Unsurprisingly, the main beneficiaries of Western sanctions appear to be third countries. For instance, one recent survey (conducted in August) found that 77% of Russian industrial companies are planning to purchase equipment from such countries as China, India and Turkey (compared to 59% a year ago), while the success of Russia’s import substitution strategy when it comes to investment goods appears questionable at best.

Against all the odds, the budget deficit target for this year is likely to be broadly met, and the overall fiscal outlook has brightened. Low energy exports this year have affected the government’s energy revenues, which historically used to account for around 40% of the federal budget. Although the recent upturn in oil prices and the rouble depreciation have brought some relief, on average in January-August 2023 these revenues were still down by 38%. However, non-energy tax revenues picked up by 24%, thanks to the economic recovery under way. Moreover, the growth in budget expenditure – which

[31] The results of macroeconomic modelling carried out at wiiw suggest that the earlier trend of declining unemployment went into reverse at the start of the war and sanctions, with a moderate rebound in the unemployment rate (Labour Force Survey) to around 4.5-5%. One reason for the discrepancy with the official statistics is that workers in the ailing automotive industry are reportedly often not registered as unemployed, but rather are sent on unpaid leave or are still on the company payroll.

was very high at the beginning of the year – has moderated and averaged a mere 12% in the period January-August. While the budget deficit reached RUB 2.4 trillion in the first eight months, the whole-year target of RUB 2.9 trillion now appears broadly realistic. Thanks to all this, the fiscal outlook for the next few years has also brightened. This is all the more important, as Russia no longer has access to international financial markets, while domestic borrowing remains quite expensive, at 11-12% in nominal terms.

On the strength of recent growth performance, our forecast for 2023 has been revised upwards to 2.3%, to be followed by a modest slowdown in the next two years. With no end to the war in sight, the current growth trajectory – based as it is in large part on military fiscal stimulus – will likely continue for some time, despite the economy suffering increased labour shortages and falling behind on the technological front, due to the Western sanctions. However, the longer the war lasts, the more addicted the economy will become to military spending, raising the risk of stagnation (or even outright crisis) once the conflict is over. Moreover, should the war culminate in Russia’s defeat, that would likely have major repercussions for domestic political stability, potentially leading to a collapse of the current regime and stoking the (by no means negligible) chances of even more nationalistic (and anti-market) political forces coming to power.

Table 6.18 / Russia: Selected economic indicators

	2020	2021	2022 1)	2022 January-June	2023 January-June	2023 Forecast	2024 Forecast	2025 Forecast
Population, th pers., average 2)	146,460	145,864	146,714	146,745	146,374	146,330	145,800	145,400
Gross domestic product, RUB bn, nom.	107,658	135,295	153,435	72,939	75,392	160,100	171,400	181,300
annual change in % (real)	-2.7	5.6	-2.1	-0.9	1.6	2.3	1.9	1.7
GDP/capita (EUR at PPP)	19,660	22,570	23,620	.	.	.	.	.
Consumption of households, RUB bn, nom.	54,752	65,811	73,260	.	.	.	.	.
annual change in % (real)	-5.9	10.0	-1.4	.	.	4.0	2.0	2.0
Gross fixed capital form., RUB bn, nom.	23,211	26,623	31,784	.	.	.	.	.
annual change in % (real)	-4.0	9.1	3.3	.	.	7.0	5.0	5.0
Gross industrial production 3)								
annual change in % (real)	-2.1	6.4	0.6	2.3	2.2	3.0	2.5	2.5
Gross agricultural production								
annual change in % (real)	1.3	-0.4	10.2	7.3	2.9	.	.	.
Construction output								
annual change in % (real)	2.1	7.0	5.2	3.7	9.2	.	.	.
Employed persons, LFS, th, average	70,601	71,719	71,974	71,733	73,167	73,410	74,140	74,510
annual change in %	-1.9	1.6	0.4	0.8	2.0	2.0	1.0	0.5
Unemployed persons, LFS, th, average	4,321	3,631	2,951	3,074	2,533	2,400	2,400	2,300
Unemployment rate, LFS, in %, average	5.8	4.8	3.9	4.1	3.4	3.3	3.2	3.1
Reg. unemployment rate, in %, eop 4)	3.7	1.0	0.8	0.9	0.7	.	.	.
Average monthly gross wages, RUB	51,344	57,244	65,338	61,853	70,058	73,800	80,500	85,700
annual change in % (real, gross)	3.8	4.5	0.3	-0.8	7.3	7.0	4.0	3.0
Consumer prices, % p.a.	3.4	6.7	13.8	14.3	5.5	5.6	4.9	3.4
Producer prices in industry, % p.a. 5)	-3.8	24.5	11.4	23.4	-6.3	-5.0	5.0	5.0
General governm. budget, nat. def., % of GDP								
Revenues	35.5	35.6	34.6	36.1	33.7	35.0	35.0	35.0
Expenditures	39.5	34.8	36.0	32.2	36.9	37.5	37.0	36.5
Deficit (-) / surplus (+)	-4.0	0.8	-1.4	3.9	-3.3	-2.5	-2.0	-1.5
General gov. gross debt, nat. def., % of GDP	17.6	15.5	14.9	12.8	15.7	17.0	18.7	20.0
Stock of loans of non-fin. private sector, % p.a.	12.4	19.8	13.6	7.5	26.9	.	.	.
Non-performing loans (NPL), in %, eop 6)	6.1	5.1	4.7	.	.	.	.	.
Central bank policy rate, % p.a., eop 7)	4.25	8.50	7.50	9.50	7.50	13.00	10.00	8.00
Current account, EUR m 8)	30,957	103,142	223,066	134,807	21,624	46,600	58,800	63,300
Current account, % of GDP	2.4	6.6	10.5	15.4	2.4	2.6	3.4	3.7
Exports of goods, BOP, EUR m 8)	291,895	417,548	558,271	279,789	191,197	404,800	433,200	454,800
annual change in %	-22.1	43.0	33.7	62.0	-31.7	-27.5	7.0	5.0
Imports of goods, BOP, EUR m 8)	210,118	256,781	261,460	115,599	138,430	289,500	304,000	319,200
annual change in %	-7.3	22.2	1.8	-0.9	19.8	10.7	5.0	5.0
Exports of services, BOP, EUR m 8)	41,973	46,920	45,854	22,750	17,835	36,800	38,700	40,600
annual change in %	-24.1	11.8	-2.3	11.9	-21.6	-19.7	5.2	4.9
Imports of services, BOP, EUR m 8)	56,666	64,136	67,168	29,371	32,990	73,100	76,700	80,500
annual change in %	-35.5	13.2	4.7	11.9	12.3	8.8	4.9	5.0
FDI liabilities, EUR m 8)	8,296	34,166	-37,836	.	.	-25,000	.	.
FDI assets, EUR m 8)	5,117	55,647	-12,393	.	.	0	.	.
Gross reserves of CB excl. gold, EUR m 8)9)	372,318	439,693	414,569	554,838	532,991	.	.	.
Gross external debt, EUR m 8)	380,941	426,299	353,872	451,995	318,192	281,500	240,000	224,500
Gross external debt, % of GDP	29.2	27.5	16.7	21.4	18.1	16.0	14.0	13.0
Average exchange rate RUB/EUR	82.39	87.20	72.48	83.31	83.19	91.0	100.0	105.0

Note: Including Crimean Federal District.

1) Preliminary. - 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.