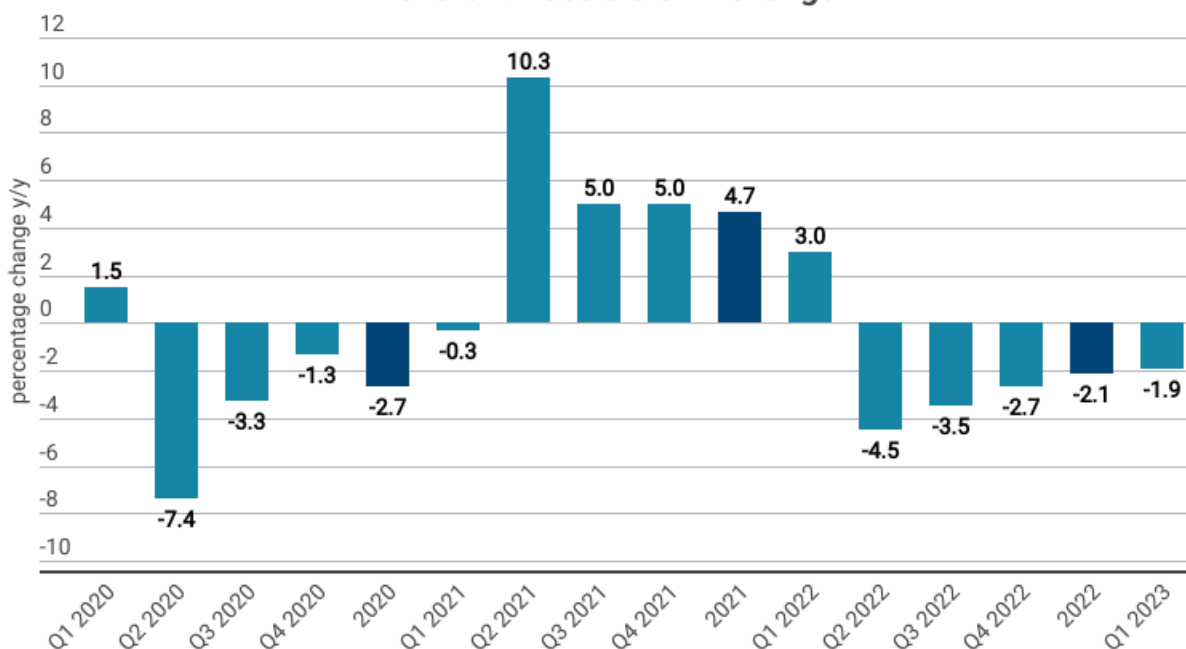


Russia: funding the war eases the consequences of sanctions

Iwona Wiśniewska

Preliminary estimates by Rosstat indicate that in Q1 2023 Russia's GDP decreased by 1.9% y/y, although earlier in its report the Central Bank of the Russian Federation (CBR) estimated the decrease at 2.3%. In this context, it is worth noting that statistics published in Russia should always be taken with a grain of salt (for more see *'The credibility of Russian economic statistics is a growing problem'*). The CBR estimates that as a whole Russia's economic growth rate in 2023 will be 0.5–2% of GDP. The CBR analysts expect to see particularly positive macroeconomic indicators in Q2 2023 figures, due to the low comparative base. Russia's economic growth in 2023 has also been announced by some international institutions; for example, the International Monetary Fund says that this rate will be 0.7% of GDP. However, some international forecasts expect recession to continue in Russia: the OECD predicts that Russia's GDP will decline by 2.5%, and the European Commission spells a decrease of 0.9%.

Chart 1. Russia's GDP change



The CBR believes that in 2023 domestic demand will be the Russian economy's driving force. This will be stimulated by growing budget expenditure and a salary level increase resulting from labour shortfall. However, in Q1 2023 this demand was 3.9% lower than the corresponding period in 2022, due to persistently low turnover in retail trade. Russian citizens mainly limited their purchases of industrial goods including cars and household appliances. Spending on services increased, mainly because of price increases in categories such as municipal and housing fees and transport services.

A major increase in spending on eating out (restaurants, bars and catering services) was recorded. However, the statistics from Rosstat suggest that this may have been linked to the ongoing war in Ukraine. For example, in Q1 2023 in the Southern Federal District (which borders on Ukraine) spending on eating out rose by more than 60% y/y (and by as much as 150% in annexed Crimea and Sevastopol). At the same time, representatives of the local tourist sector have complained about a drop in the number of tourists visiting the region. Similar anomalies have been recorded in other regions (which are less attractive tourist destinations), as exercises of mobilised troops have probably been held there.

Chart 2. Consumer demand in Q1 2023

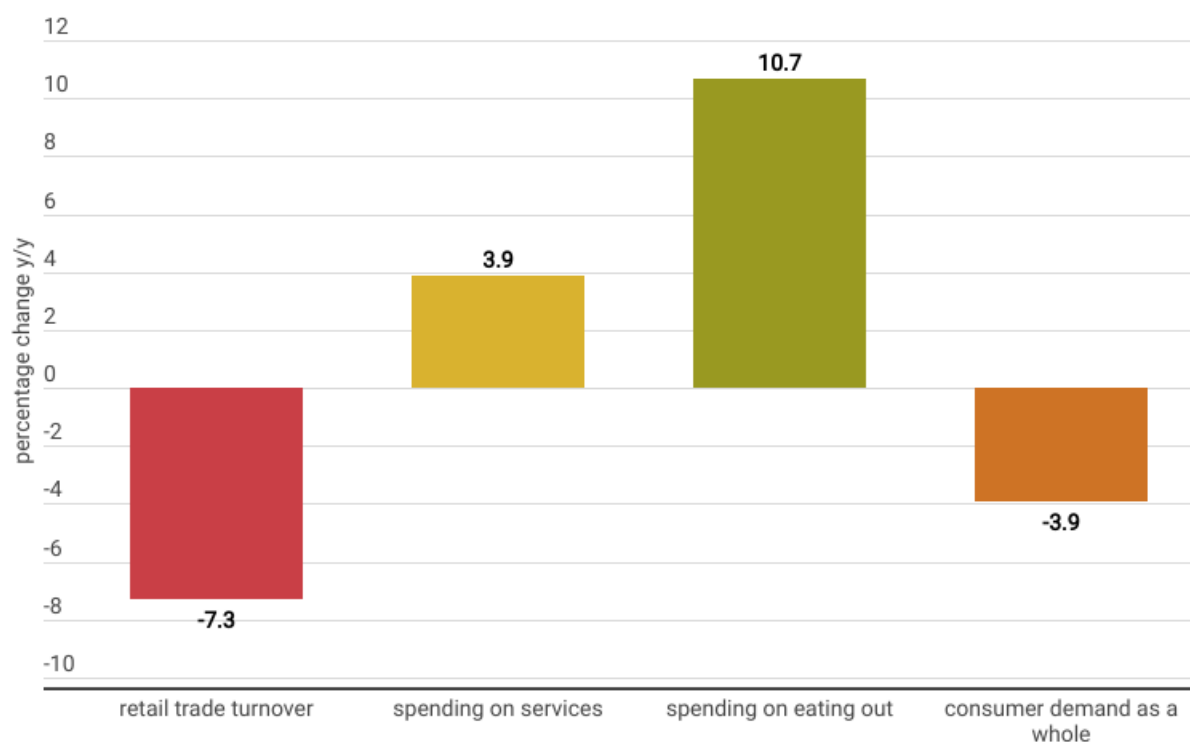
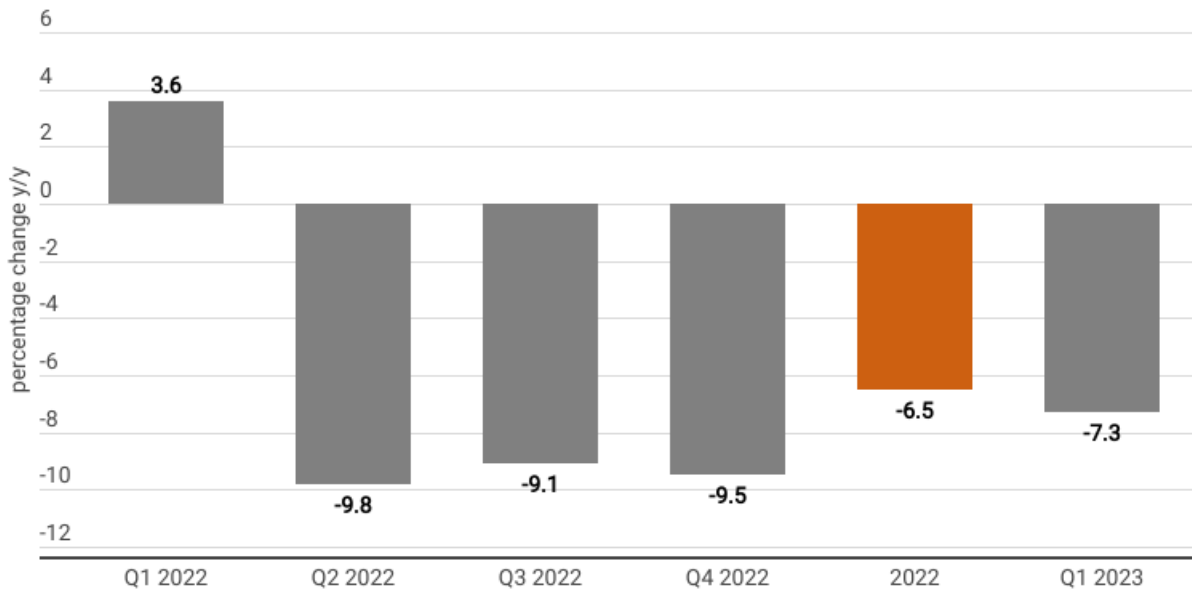


Chart 3. Retail trade turnover



Although no statistics regarding investments in Russia have been published to date, according to government forecasts investments figures are expected to increase by around 0.5% in 2023 compared with 2022. The stable level of investment is mainly due to public tenders and to funding by state and state-controlled companies of infrastructural projects (expansion of the road and railway network, gas pipelines). However Russian private businesses are increasingly reluctant to invest because of the unstable domestic situation and falling revenues. Moreover, they are increasingly being required to transfer a portion of their revenues to the state budget.

Although the rising budget expenditure creates inflationary pressure, price increases have so far been limited. In April 2023, Russia's annual inflation rate was a mere 2.3% (the figure for March 2023 was 3.5%), mainly due to the public earning low levels of income and their consequent reluctance to spend their money. At present, the inflation rate is mainly being boosted by service prices. Russian state-controlled companies have increased municipal & housing fees and the prices of transport services.

Chart 4a. Inflation rate at the end of 2022 and in 2023
(compared with December of the previous year)

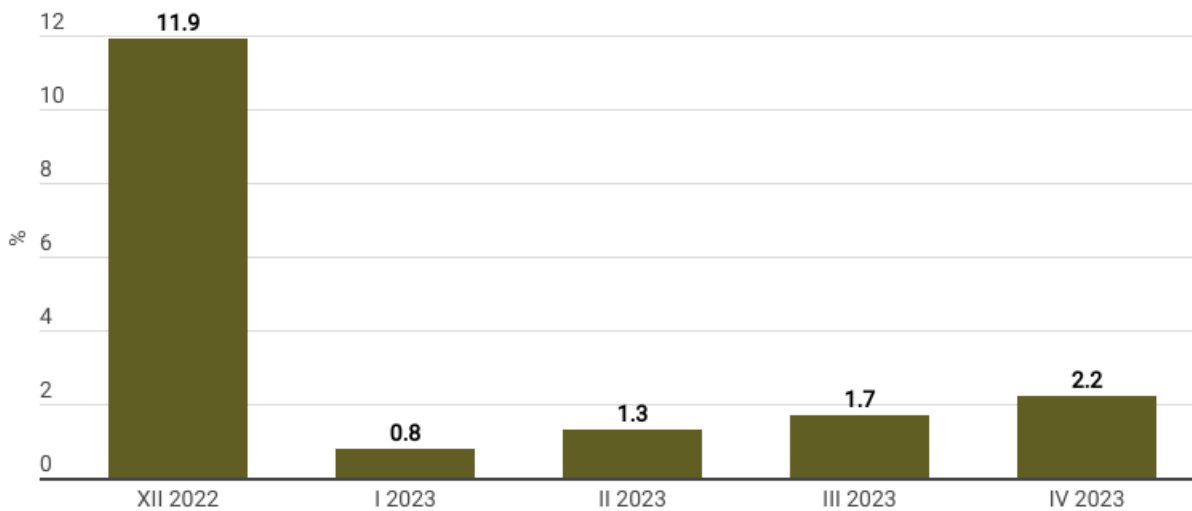
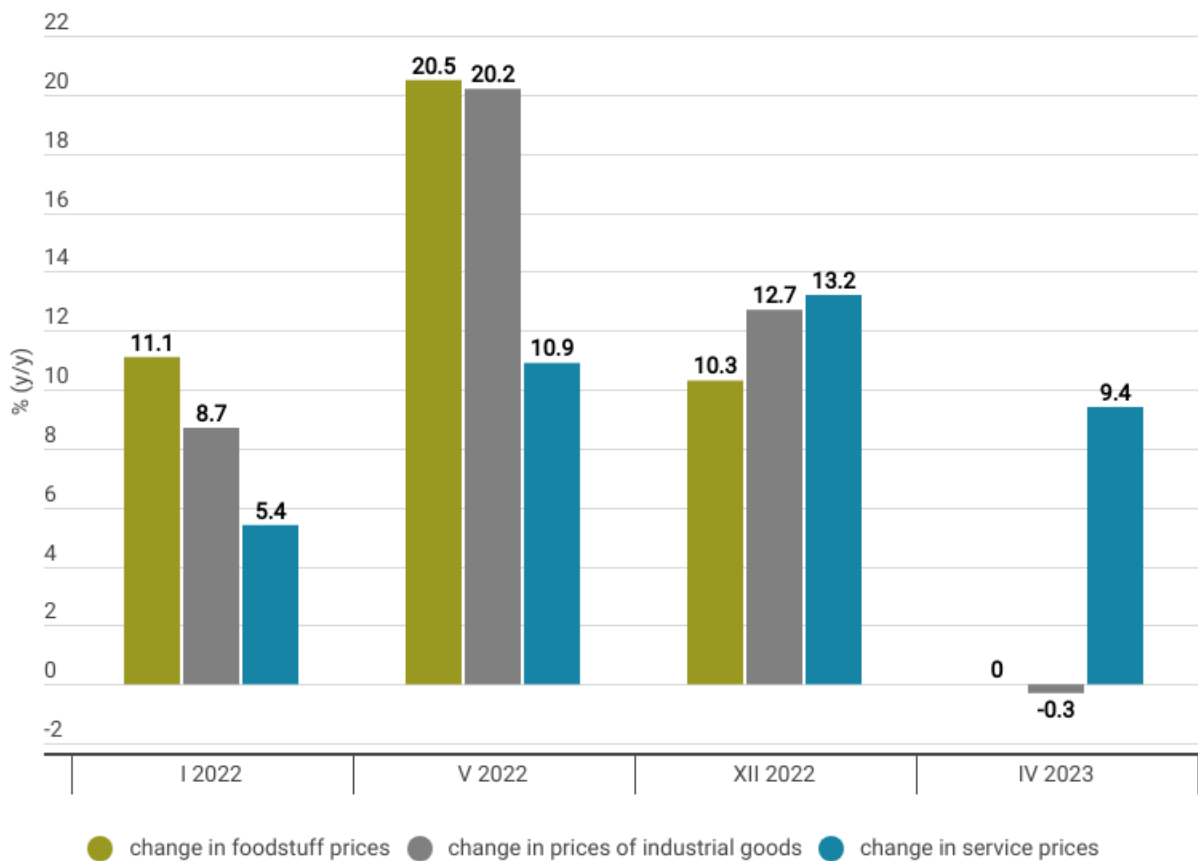


Chart 4b. Annual inflation rate



Efforts to make up for the negative effects of sanctions by increasing public spending have been particularly evident in the production industry. Statistics from Rosstat indicate that in Q1 2023 Russia's industrial production as a whole shrank by a mere 0.9%, mainly due to the

favourable figures recorded in March (the comparative base effect). In the same period the mining sector, which has been covered by Western sanctions, recorded a decrease, while industrial production, which is powered by growing demand from the military, recorded growth.

Chart 5a. Industrial production

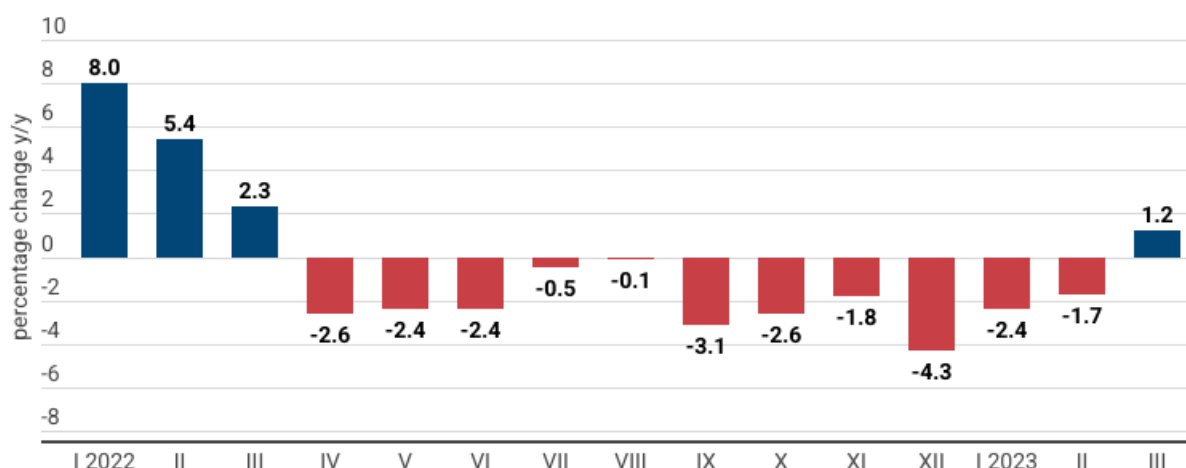


Chart 5b. Production in selected segments of the industrial sector



According to international estimates, in March 2023 Russian oil companies reduced their oil production by around 200,000–300,000 barrels daily, down to 9.6–9.7 million barrels daily, while the International Energy Agency has not to date recorded any decrease in the volume of Russia's oil exports. In March 2023, Russia's natural gas production fell by more than 15% y/y (down to 50 bcm) (the government decided to halt the publication of statistics when Rosstat had already published these figures). It was mainly Gazprom that accounted for this reduction. In 2022, it unilaterally decided to halt supplies to most EU member states.

Although companies operating in the wood processing sector are still encountering serious problems, they are increasingly frequently managing to sell their products on new markets. However, the automotive and air freight sectors are still in a particularly difficult situation (the results recorded in these two sectors did improve in March, but that was due to the low comparative base).

The magnitude of the problems faced by those sectors which have been covered by sanctions is particularly evident in the shrinking turnover figures Russian companies are recording. As oil and gas prices gradually fell, the turnover recorded by oil and gas companies decreased, by as much as 50% y/y in March 2023. Major declines have also been recorded in the coal mining and wood processing sectors. There is no doubt that significant devaluation of the Russian rouble at the beginning of 2023 greatly benefited the exporters' financial standing.

The problems faced by those sectors which have been covered by sanctions have directly affected the economic performance of the Russian regions. For example, industrial production as recorded in Q1 2023 in Kaluga oblast, Kaliningrad oblast and Primorsky krai – areas which used to host manufacturing plants run by Western automotive companies – fell by 19%, 17% and 15% y/y respectively. Meanwhile, the production decline recorded in the Yamalo-Nenets autonomous *okrug*, which accounts for 50% of Russia's gas production, was a mere 5% y/y. This resulted from the positive economic performance of Novatek (which was involved in the production of liquefied gas) and of oil producing companies, in particular Gazpromneft.

Chart 5c. Production in the sectors most affected by sanctions and counter-sanctions in February and March 2023

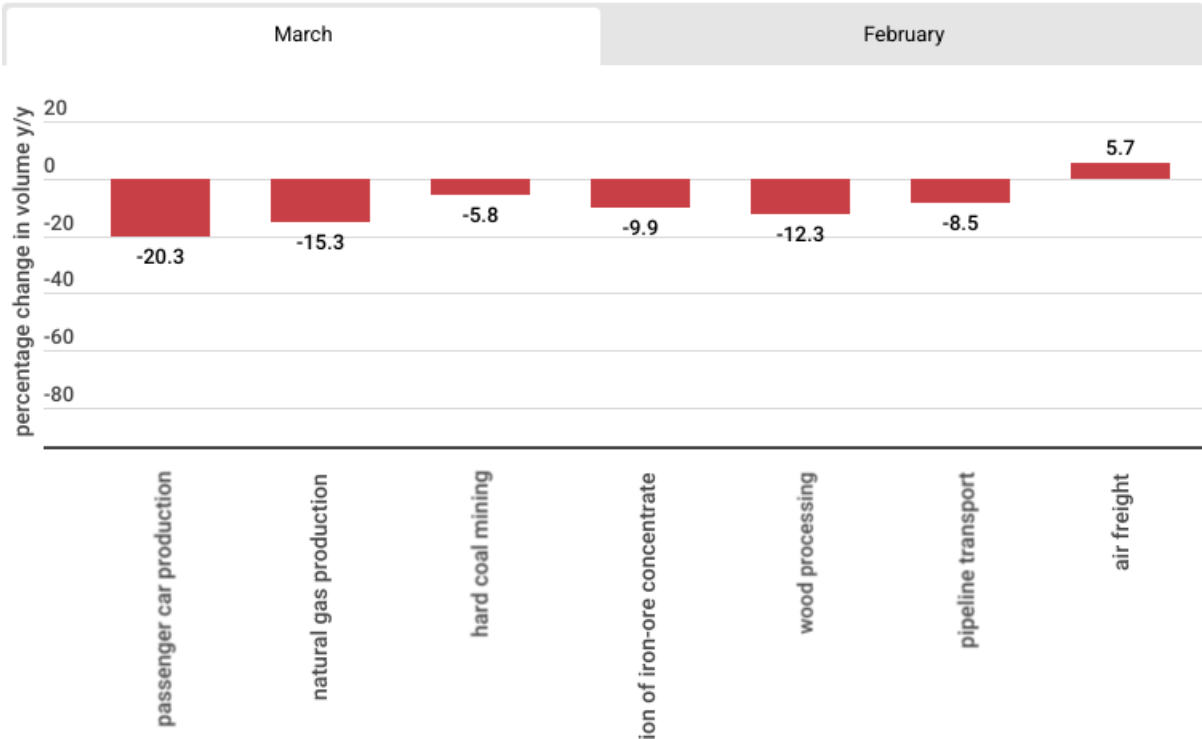
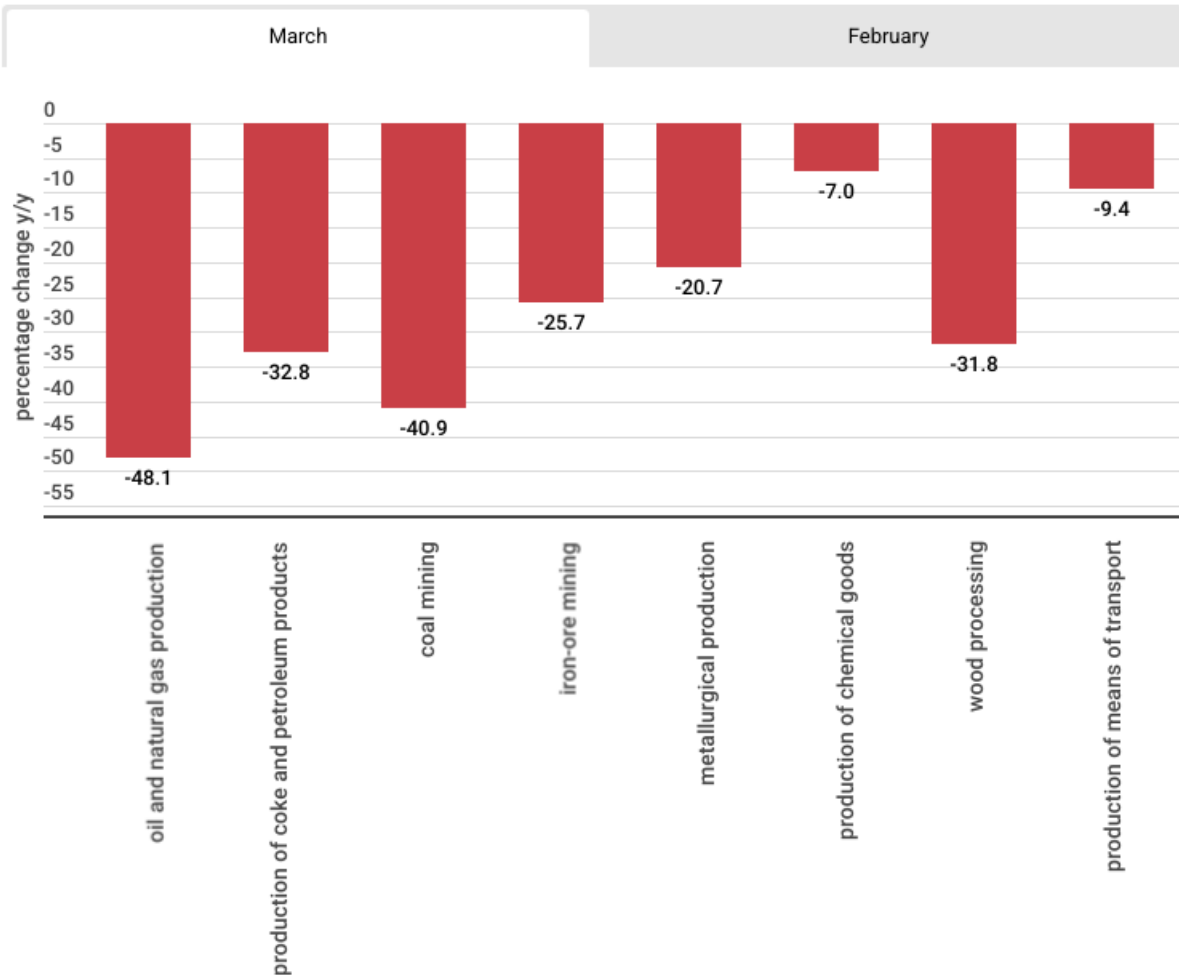
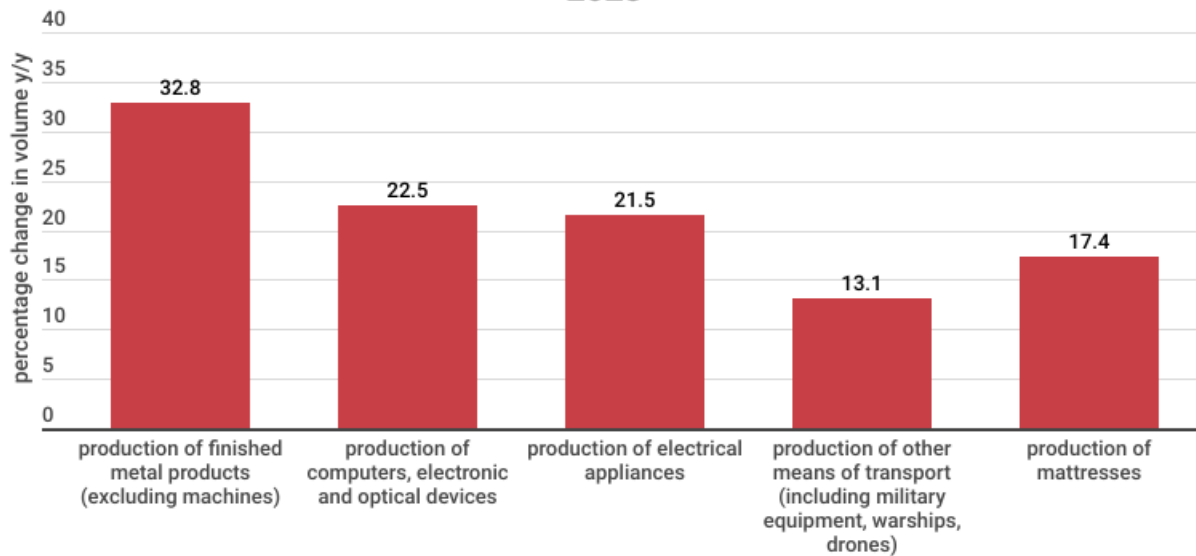


Chart 5d. Decrease in turnover in the sectors most affected by sanctions in February and March 2023



The situation in those sectors of industry which are involved in the production of goods for the military is different. Russian statistics do not report data on their results in a separate category, and only some of this information can be determined. In these sectors a double-digit increase in production volumes has been recorded: March 2023 saw a dynamic rise (of 110%) in the value of production of special-purpose clothing (mainly uniforms). However, it is unclear to what degree this increase was due to an increase in price or the number of orders.

Chart 5e. Production increase in sectors indirectly involved in the war in March 2023



Moreover, statistics published by Rosstat indicate that at the beginning of 2023 the construction sector, which in 2022 was one of the few sectors with growth figures, continued to thrive. In Q1 2023, the value of construction work rose by almost 9%, while the total floor area of houses built in that period fell by 1.2% y/y. Furthermore, data compiled by this sector indicate that the number of flats which property developers have difficulties selling is growing. As of 1 April, around 70% of flats under construction had not yet been sold to customers (in 2019 the figure was 60%). Although the Russian government has extended its preferential mortgage loan programmes, at the same time it has introduced new restrictions regarding the terms of these loans. As a consequence, the number of mortgage loans granted to customers in Q1 2023 fell by 12% y/y. The total value of these loans decreased by a mere 4%, which clearly indicates that despite the falling demand property prices have gone up. An anomalous increase has been recorded in the value of construction work in regions bordering the areas of fighting in Ukraine. In Rostov oblast and in annexed Crimea the value of construction work rose almost two-fold, which may suggest that some of this construction was linked to the ongoing war.

The CBR statistics indicate a major decline in Russia's exports in Q1 2023. The value of these exports shrank by almost 35% y/y, down to \$100 billion, due to a decrease in the export prices of Russian fuels (mainly oil), and to a decrease in the volume of natural gas, coal and timber sold to foreign partners. At the same time, import figures have returned to the levels recorded in 2022. However, due to the lack of access to detailed statistics it is difficult to establish to what degree this resulted from restoring former supply volumes or from the rise in the prices of imported goods. It should be noted that the range and structure of Russia's imports have changed significantly. For example, the halt in automotive production in Russia has resulted in a dynamic increase in the import of finished cars, which outstripped the import of automotive parts and subassemblies. At present, most imported cars are used Western cars. In Q1 2023, their import to Russia almost doubled (more than 106,000 units) compared with 2022. The import of new cars has also doubled (up to 86,000 cars), most of which were imported from China. At the same time, the number of new cars

sold in that period fell by 45% compared with 2022, and the number of used cars sold increased by 19%.

In a situation of shrinking export revenues and growing import figures, the current account surplus has decreased significantly. As a consequence, a decrease in the supply of foreign currencies available in Russia was recorded, which contributed to a major devaluation of the rouble in Q1 2023. Interestingly, despite the rising prices of foreign-made goods, Russian companies have not reduced their imports.

Chart 6. Russia's exports and imports

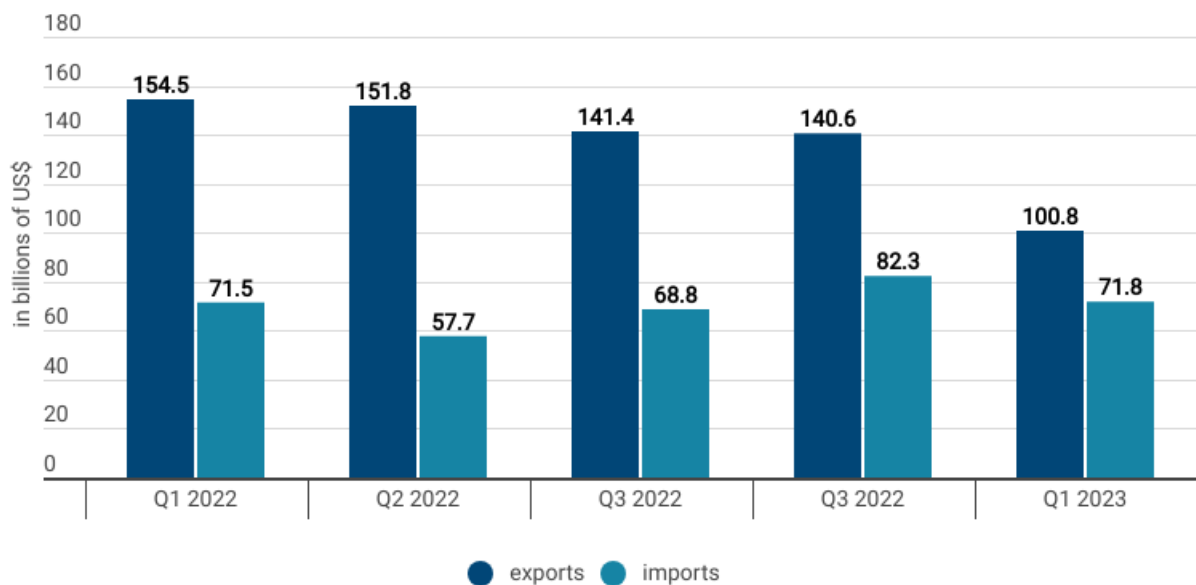
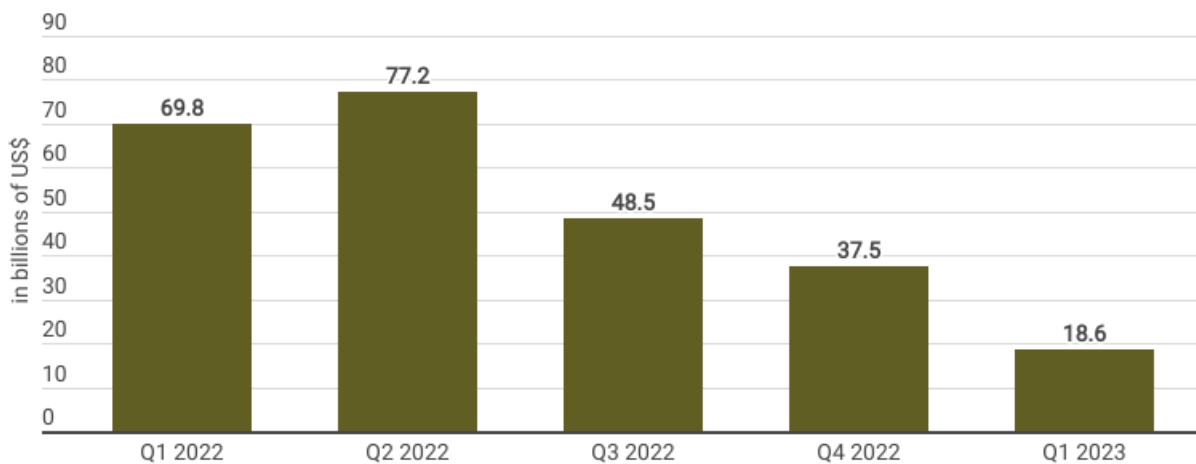


Chart 7. Russia's current account



There is no doubt that the geographical structure of Russia's foreign trade has changed over the last year. In March 2023 (that is, following the introduction of the embargo on petroleum products), the EU's imports from Russia fell by more than 80% y/y. A similar drop was recorded in the United States, while the United Kingdom has effectively halted its imports

from Russia completely. At present, Russia's main export partners include China, India and Turkey. From Moscow's point of view, it was of key importance that these countries increased their imports of the Russian oil which used to be sold on the EU market. Thanks to the discounts that Russia offers, increases in its coal and wood exports have been recorded. However, logistical problems and insufficient capacity of the Trans-Siberian Railway continue to be the most important obstacles to the diversion of Russian exports from the European to the Asian market.

An increase in the role of China, Turkey, the Central Asian states and the South Caucasus has also been recorded in Russia's imports, although India, for its part, has not yet increased its exports to Russia. As regards the EU and the UK, a year into the war the value of their exports to Russia had dropped by around 50%, despite which EU member states continue to be Russia's important import partners. Moreover, numerous press investigations have revealed that a major portion of EU-made goods which are subject to sanctions, including dual-use items, are still being sold to Russia via third countries; the EU's rising exports to these countries is probable proof of this. For example, in Q1 2023 the EU's exports to Kyrgyzstan and Armenia rose by multiple factors, to Kazakhstan by more than 100%, and to Turkey by around 30%. However, the practice of bypassing sanctions increases the cost of delivery; that favours the middlemen, most of whom are not registered in Russia.

Chart 8a. Russia's main export partners

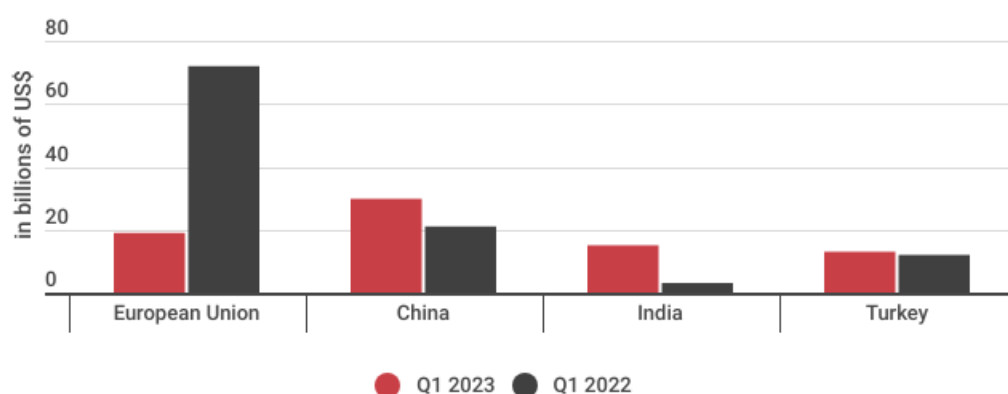
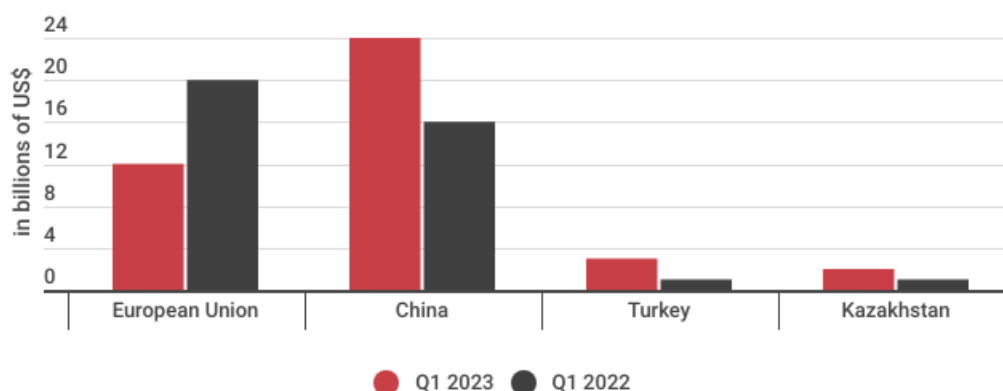


Chart 8b. Russia's main import partners

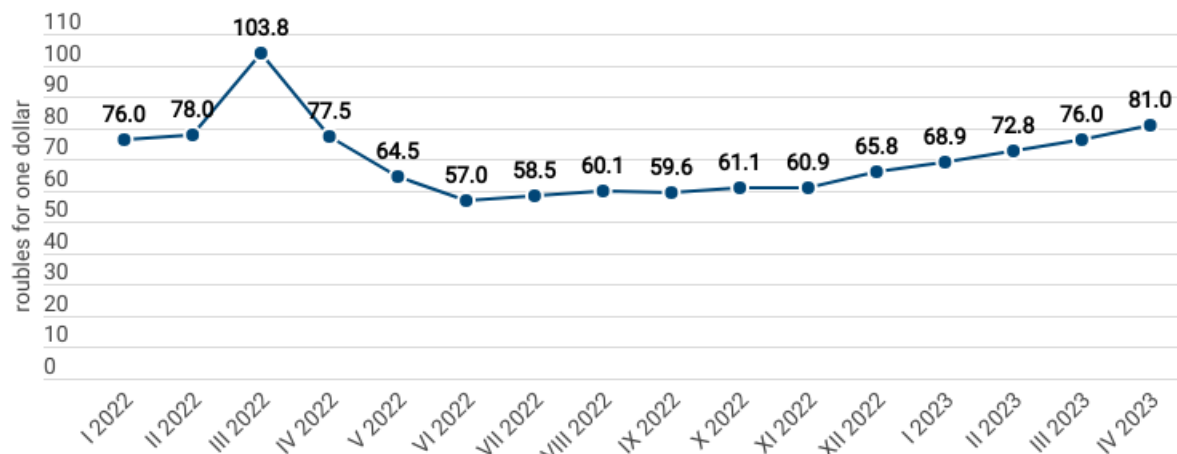


Source: statistics published by Russia's trade partners

Since the end of 2022, a dynamic devaluation of the rouble has been recorded. At the beginning of December 2022, the average exchange rate was 60 roubles to the US dollar, whereas in mid-May 2023 the rate is now more than 80 roubles. This indicates that the nominal value of the Russian currency has shrunk by more than 30%. This was mainly due to the drop in Russia's export revenues. It should be noted that a significant portion of these revenues remains abroad. The CBR's statistics indicate that in 2022 Russian exporters may have retained revenues worth more than \$140 billion in foreign bank accounts. This sum likely includes Indian rupees, as this is the currency Russian oil companies are using for oil supplies dispatched to India. There is no doubt that a portion of this sum is being used to pay for goods imported to Russia. However, most of these funds are most likely kept in foreign bank accounts in order to keep them out of Russian jurisdiction. This is done out of the exporters' fear that they will be required to share their profits with the Kremlin, or that Vladimir Putin's closest aides will seize them. In this context, the practice of keeping funds in foreign bank accounts can be viewed as a form of building up reserves for the future. A great deal of capital flight from Russia has been recorded over the last 30 years; Russian business views the Kremlin's current aggressive policy and the mounting cost of the war as a major threat.

Other reasons behind the devaluation of the rouble include the decisions taken by the Russian leadership and the central bank concerning, for example, the introduction of regulations regarding the operation of the currency market, the requirement for selected foreign investors to obtain state permission to sell their assets in Russia and to transfer their capital out of Russia (for example Shell selling its stake in the Sakhalin-2 project), and the sale of Chinese yuan from the National Welfare Fund. The rouble's exchange rate to other currencies is still *de facto* supervised by the Kremlin. The devaluation of the Russian currency is favourable to the government because it helps it to reduce the country's budget deficit. Economists believe that every time the Russian currency is devalued by one rouble to the US dollar, that increases the state budget's revenue by around 150 billion roubles.

Chart 9. Average monthly US dollar to rouble exchange rate



The introduction of the EU embargo and the price cap on Russian oil and petroleum products sold to third countries has reduced the federal budget's oil and gas revenues. The rise in the average price of a barrel of Urals oil in April 2023 (which was linked to the oil price hike on global markets) did not translate into an increase in the Russian state's oil revenues in that month (the processing of financial transactions has most likely been delayed). In the first four months of 2023, these revenues taken together were more than 50% less than the 2022 figures. This means that Russia will most likely be unable to earn the sum of 8 trillion roubles (around \$100 billion, calculated using the present exchange rate) in oil and gas revenues which had been planned for 2023. The government has attempted to make up for this deficit by increasing the tax burden shouldered by the oil and gas sector. As part of these moves, it introduced measures to regulate the price discount on exported oil and to reduce the compensation payments it offered to refineries for maintaining low fuel prices on the domestic market. Moreover, in 2023–5 Gazprom will be required to pay an additional extraction tax of 600 billion roubles per year.

At the same time, after the first four months of 2023 the revenues to Russia's state budget recorded by sectors other than the oil and gas sector turned out to be almost 5% bigger than in 2022. Russia's VAT revenues increased by more than 11% (mainly due to restored imports), whereas the revenues from CIT fell by 19%. The government has also consistently increased the fiscal burden shouldered by private companies. In mid-May 2023, it finished work on a law enabling the state to impose a windfall tax on extra profits earned by business in 2021–2. Earlier, the government decided that Western companies which intended to sell their assets in Russia would be required to transfer between 5% and 10% of the sum of any such transactions to the state budget.

Despite shrinking revenues, the Russian government is consistently increasing public spending. In the first four months of 2023, it spent almost 40% of the amount it had earmarked for this year. Since spring 2022, the government has not published any information regarding the specific spending categories. The only available information concerns the sums spent on public tenders (including in the military sector). Over the first four months of 2023, the government spent more than 2.8 trillion roubles on that purpose (a

quarter of all the amount spent, 60% more than in 2022). These funds are helping to stimulate Russia's economic activity.

As a consequence, after the first four months of 2023 Russia's federal budget deficit stood at 3.4 trillion roubles, and exceeded the forecasts for 2023 as a whole (2.9 trillion roubles). Therefore, it should be expected that by the end of the year it will be twice as high as the sum defined in the budget act.

Chart 10. The federal budget's revenues and expenditures

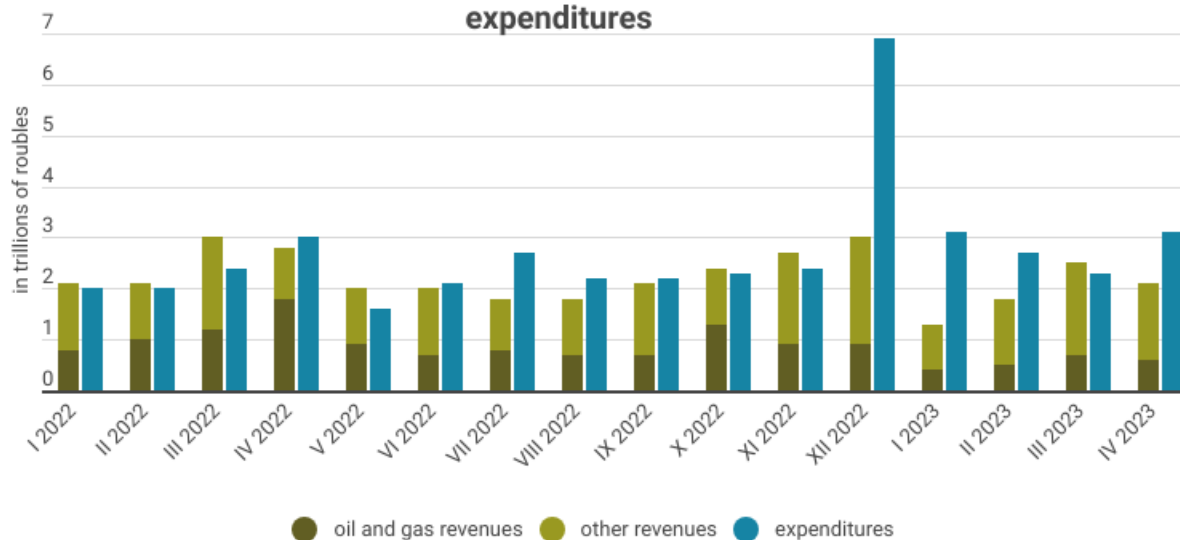


Chart 11. Average price of a barrel of Urals oil

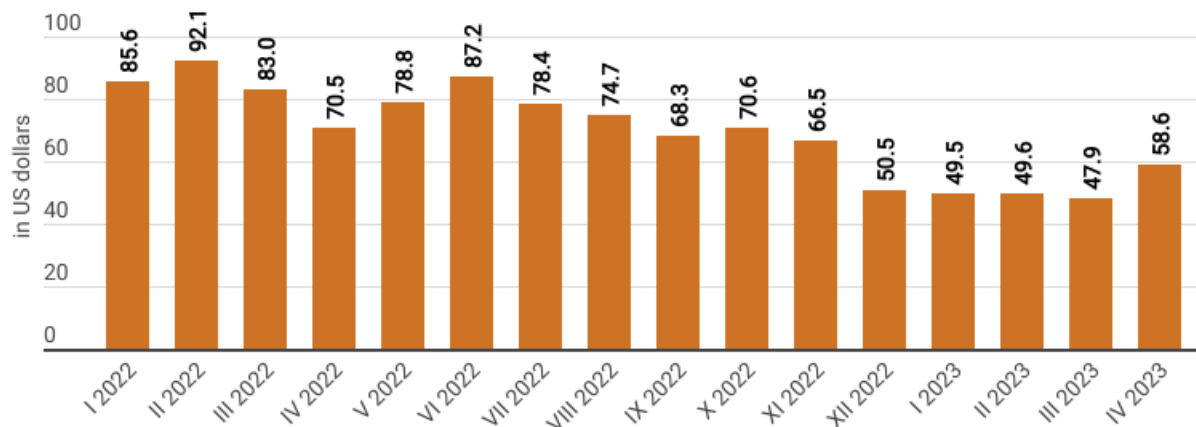
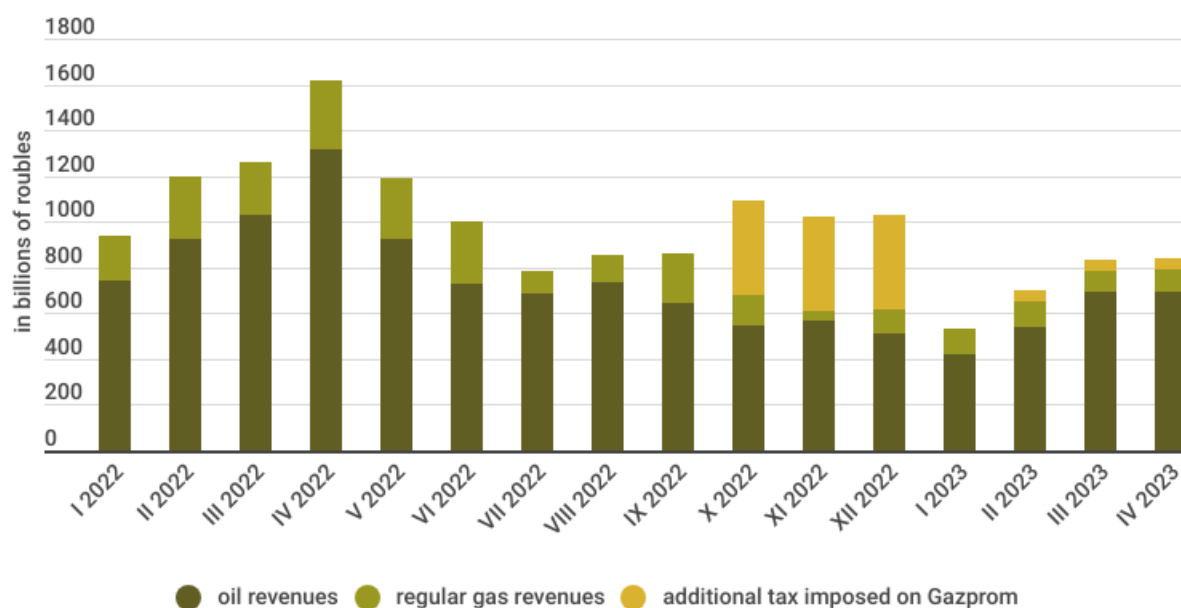


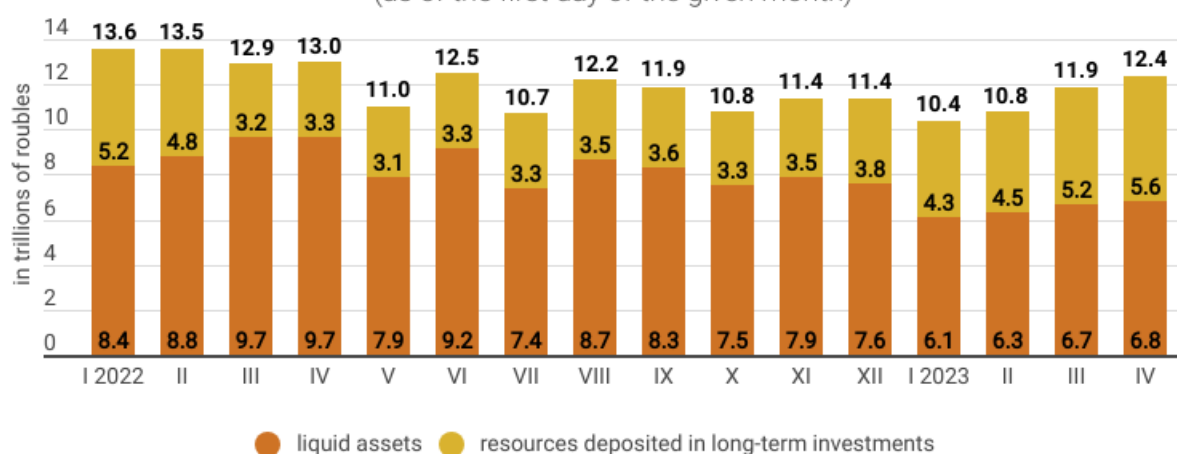
Chart 12. The Russian state budget's oil and gas revenues



The government is using several methods to fill in the budget gap. To make up for the missing oil and gas revenues, it has been using the resources of the National Welfare Fund (NWF); the government has drawn more than 400 billion roubles from it since the beginning of 2023. The NWF funds are also being used to support Russian state-controlled companies such as the Russian Railways and air carriers. Despite this, due to the recent devaluation of the rouble, in the first months of 2023 the value of NWF funds as expressed in roubles rose. At the beginning of April 2023, the NWF's liquid assets (which are available to the government) stood at 6.8 trillion roubles. However, when converted to dollars (at present the NWF's resources are deposited in gold, Chinese yuan and a small portion in euros) the value of these assets was more than \$3 billion less than at the beginning of the year (\$84.8 billion as of 1 April 2023).

Chart 13. The resources held by the National Welfare Fund, including liquid assets

(as of the first day of the given month)



The government has also increased the sale of sovereign bonds on the domestic market. In the first four months of 2023, it borrowed as much as almost 1 trillion roubles. It should be noted in this context that Russia's total government debt continues to be low, at less than 20 trillion roubles, i.e. around 12.5% of the country's GDP. Another method the Russian government can apply to boost the state budget's revenues involves devaluing the rouble. However this policy has certain limitations, as it may curb imports which the Russian economy needs, and may contribute to price hikes. The most common method which the government can resort to in this context involves increasing the tax burden shouldered by businesses and ordinary citizens (some of whom continue to hold major assets). However, such moves will pose a threat to consumer demand and Russian companies' manufacturing potential. It is possible that the government will abandon some of the planned expenditures which are of lesser importance in the context of the ongoing war.

Although the Russian government has announced that domestic demand is expected to be the driving force of the Russian economy in 2023, so far Russian citizens' real income has not increased. In Q1 2023, the real value of pensions (senior citizens are the government's main support base) rose by more than 5% y/y. Raises in salaries have been only minor, despite the country's labour shortfall. In March 2023, Russia's unemployment rate stood at a record low of 3.5%. A poll conducted by the Gaidar Institute for Economic Policy showed that in April 2023 35% of Russian business owners complained about labour shortfall: the situation was most difficult in light industry and in the food processing sector. However, business owners remain reluctant to raise salaries: in the first two months of 2023 (no data is available for subsequent months) real wages offered by big companies rose by a mere 1.7% y/y. The biggest nominal salary increase was recorded in organisations which are indirectly involved in the war. In the state administration and bodies responsible for ensuring security (including the military), salaries rose by almost 18%, and in science and research institutions by the same percentage. Similar raises were recorded in production companies which carry out public tenders. As a consequence, it is these sectors that employees are migrating to, encouraged not only by the higher salaries but also by the prospects of draft deferment in case of mobilisation.

Statistics compiled by Rosstat indicate that, despite the GDP decline and shrinking citizens' real income, Russia's poverty rate fell in 2022. 15.3 million citizens were living below the minimum subsistence level (around \$170), 700,000 fewer than the previous year. However, Rosstat offered no explanation for this finding. It is thus unclear whether it was linked to Russia's declining population as recorded over the last few years (in 2022 Russia's population shrank by 600,000 individuals). It is also likely that in 2022 the decline in living standards mainly affected the Russian middle class, while the poorest groups of citizens received welfare benefits from the state. Moreover, men from these groups were often conscripted to the army. They received the high remuneration which the state offers to soldiers fighting in Ukraine, and in the event of their death their families were entitled to generous benefit payments.

Chart 14. Citizens' real income

