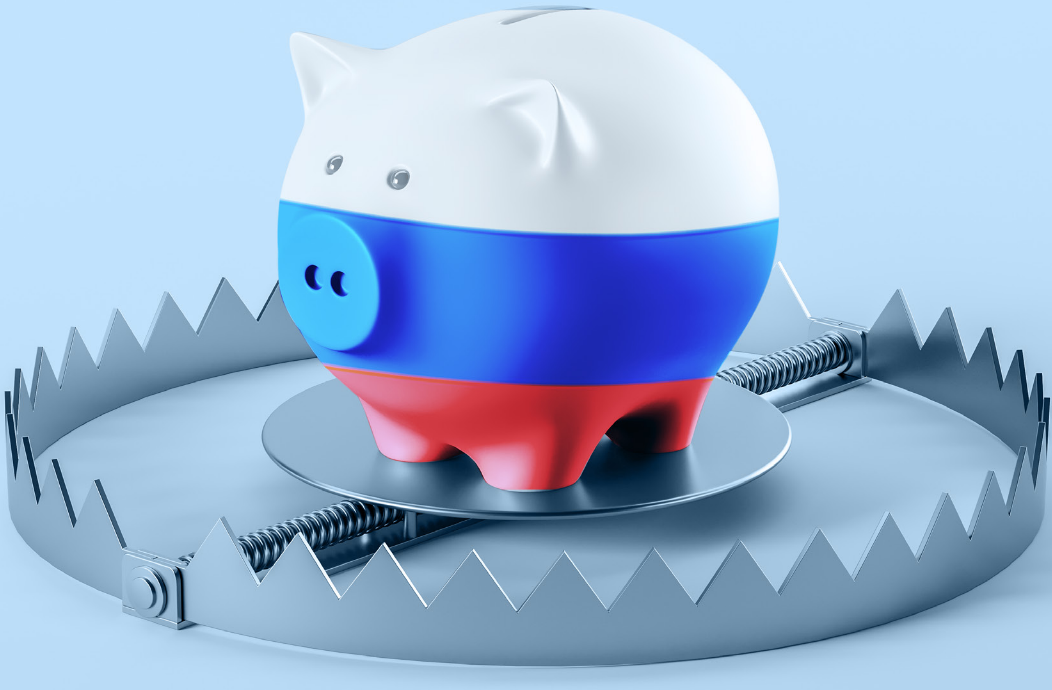
Russian Economy:

Still Standing, But Stuck

Vladimir Milov

Wilfried Martens Centre for European Studies



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Wilfried Martens Centre for European Studies
Rue du Commerce 20
Brussels, BE 1000

For more information please visit: www.martenscentre.eu

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About the author

Vladimir Milov is a Russian statesman, politician, and economist. He worked in the Russian government in the period 1997–2002 and was engaged in major reforms (in his capacity as deputy energy minister in 2002, he was the author of the concept of unbundling Gazprom), before leaving the government in late 2002 to become a vocal critic of Putin's reversal of democratic and market reforms. Since 2008, Mr Milov has published a series of comprehensive joint reports with the late Boris Nemtsov, critically assessing Putin's political and economic legacy. These include *Putin: The Results* and *Putin and Gazprom*. In 2017-2024, Mr Milov worked as economic and international affairs advisor to the late Russian opposition leader Alexey Navalny and continues to collaborate with Navalny's team. Mr Milov is also Vice President of the Washington-based Free Russia Foundation.

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This analysis is a follow-up to the comprehensive report “From Bad to Worse: The Continuing Effects of Sanctions on Russia”, which was published by the Wilfried Martens Centre for European Studies in June 2023. We continue to analyse the nuanced effects of Western sanctions against Russia two years since the beginning of Putin’s full-scale invasion of Ukraine, and, in contrast to the widespread international optimistic assessment of “Russia’s economic resilience” to sanctions, paint a very different picture: behind the facade of a handful of positive macroeconomic indicators like strong GDP growth and low unemployment, Russia’s actual economic reality is much bleaker, and the situation is getting worse.

This paper intends to provide Western policymakers with realistic in-depth analysis of multiple effects of sanctions on the Russian economy, helping to identify areas where sanctions are truly working, and Putin’s main economic vulnerabilities, an understanding of which is crucial to further strengthening the Western response to Putin’s war of aggression against Ukraine, and limiting Russia’s ability to finance the war.

Is the Russian economy really that resilient?

Many of the upbeat assessments of how the Russian economy is coping with the consequences of war and sanctions are, unfortunately, unwisely narrowed down to just one dynamic - annual GDP growth. The IMF forecasts Russian GDP growth in 2024 to be as high as 2,6%, following 2023 growth figures of over 3,5% after a relatively mild contraction of 1,2% in 2022[1]. These figures may indeed look impressive - particularly on the background of earlier expectations by some that the Russian economy would “collapse” in the aftermath of Western sanctions.

But do GDP dynamics really tell us anything? In times of deep structural crises, they can be very misleading - remember, the USSR remained GDP-positive until 1991, the year the Soviet Union collapsed. The same is true about the current Russian situation. Just a very brief dissection of the economic facts paints a different picture: the positive GDP dynamics are driven by a very narrow handful of sectors, mostly related to military production, which is insufficient to ensure sustainable growth, while most other sectors are seriously depressed. Military industries, in turn, can only thrive while there are sufficient state funds to finance them - but the government’s financial resources available for that purpose are rapidly shrinking.

On the background of this, there is rampant inflation, which prompted the Russian Central Bank to maintain growth-prohibitive high interest rates; nearly all factors arising from the war and Western

[1] The Financial Times. “IMF raises Russia growth outlook as war boosts economy”. https://www.ft.com/content/21a5be9c-afaa-495f-b7af-cf937093144d. Accessed February 20 2024.

sanctions – a sharp ruble depreciation, budget deficit spending, a shortage of skilled workers, expensive trade logistics with Asia - are pro-inflationary in the long run, which means that inflation won't significantly recede without deliberate efforts to cool the economy. Investments are not coming in, the government is forced to introduce new draconian measures like windfall taxation of export-oriented industries or strict currency controls, which take their toll on industries and investment. Import substitution is not truly working, and most indicators suggest that it won't. Russia is replacing Western goods with those coming from China and other countries of the Global South - but these are significantly more expensive, while Russian commodities are being sold to Asian markets with significant discounts (and higher costs of delivery, which means lower margins). A sustainable economic model to go ahead is absent.

All these issues will be considered below in more detail, but let's come back to the main indicator in question: GDP growth. Just one look at a breakdown of GDP growth into specific components, as provided by the Russian official statistics agency, Rosstat, proves a simple thing: growth is mostly concentrated in a very narrow group of sectors related to military production - as well as in the construction sector, which has actually been growing fast, but only to produce some sort of real estate bubble, an enormous amount of unsold housing:

"The increase in GDP by 3,6% [in 2023] was most influenced by the growth of indices of physical volume of added value in the following industries: manufacturing industries - +7.0% (the increase is due to an increase in the production of computers, electronic and optical products by +32.8%, finished metal products by +27,8%, other vehicles and equipment by +25,5%) … and construction – +7,0%" (source: Rosstat[2]).

Table 1. Key components of Russian GDP growth in 2023

	Growth in 2023, % (compared to 2022)
"Computers, electronic and optical products" - radar devices, radio electronics	32,8 %
"Finished metal products other than machinery and equipment" - production of weapons and ammunition	27,8 %
"Other transport facilities and equipment" - military aircraft, tanks, and armoured vehicles	25,5 %
Construction	7,0 %
Overall GDP growth	3,6 %

Source: Rosstat[3]

[3] Rosstat. "Росстат представляет первую оценку ВВП за 2023 год" ("Rosstat presents the first GDP estimate for 2023"). https://rosstat.gov.ru/folder/313/document/230009. Accessed February 20 2024.

The construction boom, so far, has led to the development of a major bubble in the housing market - by the end of 2023, the amount of unsold housing in Russia has exceeded a record number of over 71 million square meters . At the same time, the Russian Central Bank expects significant cooling of real estate demand in Russia due to the excessive credit leveraging of households . This situation is reminiscent of the real estate bubble currently being observed in the Chinese economy, which is taking a significant toll on China's economic prospects – the Russian situation is, in many aspects, fairly similar.

So, nominally, Russian GDP growth may look impressive on the background of sanctions - but in reality, it says very little about the actual state of the Russian economy. Notably, major sectors of the Russian economy, according to official statistics, have shown limited growth or contraction in 2023 - agriculture and cargo turnover have both contracted, whereas industry has shown only a modest growth of 3,5%, which is clearly mostly driven by military-related production, while overall growth of the remaining industries was much lower. Please note that these are figures compared to 2022, which means that in many areas, the economic situation continued to deteriorate further.

Table 2. Real sector growth indicators in Russia are much weaker than GDP

	Growth in 2023, % (compared to 2022)
Industry output total (including military industries)	3,5 %
Agriculture	-0,3 %
Cargo turnover	-0,6 %
Extractive industries	-1,3 %

Source: Rosstat[6]

Skyrocketing growth in military industries is not surprising, given the jump of military spending from 2,6% of GDP as per the approved state budget for 2022 (before the beginning of Putin's full-scale invasion of Ukraine in February 2022) to 6% of GDP in 2024. Military production consumes about two-thirds of the overall Russian military budget, while the army itself receives only about a third[7]. But other, non-military sectors of the economy are doing much worse, with military production clearly distorting the picture. Profitability of most sectors of the economy, except for military industries and banks, was stagnating or shrinking throughout 2023, which means that the rest of the economy apart from military-related sectors is not doing that well[8].

[6] Rosstat. "Социально-экономическое положение России, 2023" ("Socio-economic situation of Russia, 2023"). https://rosstat.gov.ru/storage/mediabank/osn-12-2023.pdf, pages 6, 23. Accessed February 20 2024.

[7] Source: author's estimate based on available open data on military spending, Gaidar Institute estimates, and state military hardware procurement data by specific manufacturers

[8] Rosstat. "О финансовых результатах деятельности организаций в январе-ноябре 2023 года" ("On financial results of organizations in January-November 2023"). https://rosstat.gov.ru/storage/mediabank/12_31-01-2024.html. Accessed February 26 2024.

How much money still left for Putin?

For how long will Putin be able to finance such high levels of military spending? The state's financial reserves keep shrinking - not as rapidly as some expected at the beginning of the full-scale invasion, but significantly. By April 1st, 2024, the overall amount of the National Wealth Fund (NWF) has contracted to RUR 12,5 trillion ($136 billion), as opposed to RUR 13,6 trillion ($184 billion) in the beginning of 2022[9]. However, the liquidity portion of the NWF - actual cash and gold in the accounts of the Ministry of Finance in the Central Bank - has been disappearing at a faster pace: from RUR 8,8 trillion ($113 billion) at the beginning of 2022 to just RUR 5 trillion ($53,5 billion) by April 1st 2024[10].

While the liquidity portion of the NWF made up about 65% of the total NWF amount in early 2022, it is down to only about 40% now - this happened because a significant part of the NWF was invested into corporate securities of Russian state companies. These funds are still available, but not for immediate spending. The non-liquidity portion of the NWF also includes $3 billion lent to Ukraine's ex-President Victor Yanukovich in late 2013 during the Euromaidan revolution - Russia will not be able to recover these funds from Ukraine. It also should be noted that about 40% of the NWF liquidity reserves are stored in gold[11] (the remaining 60% in Chinese yuan), which means that they may be difficult to be recovered immediately: the price of gold is negatively sensitive to large offerings on the market, and Russia has difficulties selling its gold due to Western sanctions.

At the same time, the Russian military budget expanded rapidly. While in early 2022 the liquidity portion of the NWF was sufficient to finance the military budget that existed back then for 30 months, its financing capacity is down to only 5,5 months now. Putin is running short of cash. Arguably, the Russian Ministry of Finance will be quite cautious with spending the remaining liquidity portion of the NWF to finance budget deficits and the war, as Russia is running quite close to reaching the bare minimum of available reserve funds, which may put it in a dangerous position should emergencies occur.

To finance the war against Ukraine, Putin has expanded Russia's military budget for 2024 to RUR 10,7 trillion, or 6% of the GDP - that's double the amount spent in 2023, and triple the amount of the pre-war year of 2021. But is it sustainable? That remains an open question. There are no clear sources available to finance such impressive growth in spending. The federal budget for 2024 envisages RUR 35 trillion in federal spending - an increase of over 22% compared to 2023[12] . It is unclear where the extra money will come from. Oil prices are not increasing: in early 2024, Russian Urals crude oil was still sold at a significant discount, mostly below $70 per barrel[13] (the federal budget for 2024 is based on an assumption of average Russian oil export price above $71 per barrel throughout 2024).

[9] Russian Ministry of Finance. "Объем Фонда национального благосостояния" ("Volume of the National Wealth Fund"). https://minfin.gov.ru/ru/document?id_4=27068-obem_fonda_natsionalnogo_blagosostoyaniya. Accessed April 29 2024.

[10] Russian Ministry of Finance. "О результатах размещения средств Фонда национального благосостояния" ("On the results of placement of funds of the National Wealth Fund"). https://minfin.gov.ru/ru/press-center/?id_4=38935-o_rezultatakh_razmeshcheniya_sredstv_fonda_natsionalnogo_blagosostoyaniya. Accessed April 29 2024.

[11] Ibid.

[12] Russian State Duma. "Федеральный бюджет 2024-2026: основные цифры" ("Federal budget for 2024-2026: main figures"). http://duma.gov.ru/news/58339/. Accessed February 20 2024.

[13] Interfax. "Brent подорожала до $82,33 за баррель" ("Brent rose to $82.33 per barrel"). https://www.interfax.ru/business/946334. Accessed February 20 2024.

The Russian government hints that extra revenues are to be derived from increased taxation: both elevated "tax collection administration" pressure on businesses, as well as extra windfall taxation of the export industries[14]. In 2023, the government has already introduced changes to the Russian Tax Code, making windfall profit taxation for exporters a permanent mechanism[15].

But the evident consequence of increased taxation will be the shrinking of capital investments - in the same way as it happened in the late 1980s, when the Soviet government was reluctant to cut budget spending, instead preferring to derive extra revenues from mineral exports, causing major underinvestment and output collapse, as described in detail in Yegor Gaidar's book "Collapse of an Empire"[16]. Windfall taxation has already forced Gazprom to cut its annual capital expenditure program for 2024 by 32% as compared to the initial level of capital spending program for 2023 as approved in end-2022[17]. The State Duma Energy Committee Chairman Pavel Zavalny has predicted that Gazprom may end up with losses as high as up to 1 trillion rubles in 2025, partially due to tax hikes[18].

The unrealistic official budget revenue forecast for 2024 prompted major Russian businessmen to sharply criticise the government in unflattering terms: oligarch Oleg Deripaska compared the Russian budget system confronting the reality in 2024 against rosy revenue expectations to "butt-hitting the ice"[19].

Just the planned deficit of the Russian federal budget for 2024 is approved as RUR 1,6 trillion, or 33% of the remaining liquidity portion of the NWF; should the revenue remain insufficient, as can be well expected, the threat of elimination of the remaining cash reserves becomes even more real already this year. After first three months of 2024, federal budget deficit has reached RUR 0,6 trillion, or almost 40% of the planned annual figure[20].

All this clearly indicates that the Russian state budget is unsustainable, that the government is running low on financial reserves and doesn't have realistic tools of increasing revenues without impairing economic recovery, and that Putin's financial abilities to continue the major war effort are under serious pressure.

[14] Forbes Russia. "Силуанов объяснил, «где взять деньги» на рост бюджетных расходов" ("Siluanov explained "where to get the money" to increase budget expenditures"). https://www.forbes.ru/finansy/498498-siluanov-ob-asnil-gde-vzat-den-gi-na-rost-budzetnyh-rashodov. Accessed February 20 2024.

[15] Interfax. "Путин подписал закон о налоге на сверхприбыль для крупных компаний" ("Putin signed a law on excess profit tax for large companies"). https://www.interfax.ru/business/914874. Accessed February 20 2024.

[16] Yegor Gaidar, "Collapse of an Empire: Lessons for Modern Russia", Brookings Institution Press, 2007.

[17] Interfax. ""Газпром" сократит инвестпрограмму-2024 до 1,57 трлн руб. с 2 трлн руб. в 2023 г." ("Gazprom will reduce the 2024 investment program to 1,57 trillion rubles from 2 trillion rubles in 2023"). https://www.interfax.ru/business/932868. Accessed February 20 2024.

[18] TASS. "В ГД заявили об убытке "Газпрома" в 1 трлн рублей из-за роста налогов и снижения экспорта" ("The State Duma announced a loss of 1 trillion rubles for Gazprom due to increased taxes and decreased exports"). https://tass.ru/ekonomika/19222403. Accessed February 20 2024.

[19] RIA Novosti. "Ситуация с бюджетом будет похожа на "удар попы об лед", допустил Дерипаска" ("The budget situation will be similar to "butt-hitting the ice," Deripaska admitted"). https://ria.ru/20231123/deripaska-1911317329.html. Accessed February 20 2024.

[20] Russian Ministry of Finance. "Предварительная оценка исполнения федерального бюджета в 1 квартале 2024 года" ("Preliminary assessment of federal budget execution in the 1st quarter of 2024").

Sanctions effects: exports down, imports up, ruble under pressure, inflation rages on

Alongside increased pressure on the government's finances and budget revenues, Western sanctions against Russia have produced two very important effects:

- Exports have been shrinking significantly due to Western embargoes against Russian oil and other minerals, and ceasing natural gas purchases by most of the EU member states from Gazprom;
- Imports became more expensive due to increasing logistical costs of trading with Asia, as well as Chinese and other Asian countries taking advantage of Russia's desperate need to substitute Western products, selling manufactured products to Russia at a premium.

According to Rosstat, data based on the information from the Russian Customs Service, Russian export revenues in 2023 have shrank by 28,3% year-on-year, while the cost of imports increased by 13,6%[21]. According to the Russian Central Bank, Russia's current accounts balance in 2023 has shrank by nearly 5 times in 2023, from a $238 billion surplus in 2023 to just $50 billion in 2023[22]. Cargo transportation costs increased by 49,6% in December 2023 as compared to December 2021, according to Rosstat[23] - clearly as a result of the pivot towards trading with Asia.

Shrinking currency surplus puts immense pressure on the ruble, which has lost about half of its value now as opposed to June 2022, when its value peaked after the draconian currency controls introduced by the Central Bank in the immediate aftermath of Putin's full-scale invasion of Ukraine. In recent months, Russia was only able to stabilise the ruble rate at just below 100 rubles per dollar only through introducing tough requirements for exporters to mandatorily convert nearly all of their currency revenues into rubles - according to Central Bank Chairman Elvira Nabiullina, by end-2023, exporters were selling nearly 100% of their currency revenue[24].

This puts exporters - who also face additional windfall taxation and other extra regulatory measures and negative consequences of sanctions - under severe additional pressure. Russian business is heavily lobbying to discontinue the mandatory requirement for selling nearly all their currency revenue since Spring. However, the Russian Finance Ministry wants it to be extended; it is likely that, if the decision on extension of mandatory currency revenue sales will happen, businesses will simply find ways to circumvent it through the establishment of shell companies, as happened massively in 1990s and early 2000s, leading to the subsequent abolishment of the measure. Extension or no extension, it seems that in, any case, the stabilising potential for the ruble from mandatory currency sales by exporters is reaching its end.

[24] BFM. "Глава ЦБ: доля продаж валютной выручки экспортерами может приблизиться к 100% в ноябре" ("Head of the Central Bank: the share of sales of foreign currency earnings by exporters may approach 100% in November"). https://www.bfm.ru/news/540837. Accessed February 20 2024.

[25] Interfax. "Инфляция в РФ с 15 по 22 апреля составила 0,08%, в годовом выражении осталась чуть выше 7,8%" ("Inflation in the

[246]Russian Federation from April 15 to April 22 amounted to 0,08%, in annual terms it remained slightly above 7,8%"). https://www.interfax.ru/business/957608. Ac-cessed April 29 2024.

A depreciating ruble has a major negative effect on consumer prices. Despite Putin boasting about "bringing inflation below 3%" in the first half of 2023, by the end of the year, it rose again to around 7,5% in annualised terms, and doesn't show signs of receding. In mid-February, inflation rose to over 7,8% in annualised terms , outside the Central Bank's forecast corridor of 7,0-7,5% for 2024. Inflation seems to become a perpetual factor, as most factors currently shaping the Russian economic situation are pro-inflationary:

- Sharp ruble depreciation;
- Budget deficit spending;
- Shortage of skilled workforce due to war, mobilisation, and mass exit of skilled personnel from the country;
- Expensive logistics of trade with Asia and more expensive prices for imported Asian goods.

The Central Bank has been trying to calm down inflation by sharp hikes of its key interest rate, which was increased to 16% from 7,5% in July 2023 - but, after nine months of rate hikes, the Russian monetary regulator was not able to bring inflation down. After Central Bank's meeting on April 26th, 2024, Central Bank Chairman Elvira Nabiullina admitted that "it is so far impossible to say that the slowdown of inflation has become steady", "we still do not observe the economic trends that are generally typical of steady disinflation", and "to return inflation to the target of close to 4%, we will need to maintain tight monetary conditions for a longer period"[26].

High interest rates are growth-prohibitive: no viable business returns can justify current interest rates. Russian business Ombudsman (and an actual employee of the Kremlin administration) Boris Titov openly states, that with the current monetary policy, Russian economic development will "curdle, freeze"[27]. This, on top of the extra taxation, tight capital controls, and increasing regulatory pressure on the Russian business, as explained above.

This is a picture of the very serious impact caused by Western sanctions on the Russian economy - contrary to the "resilience" fanfare often portrayed in Western media.

[26] Central Bank of Russia. "Statement by Bank of Russia Governor Elvira Nabiullina in follow-up to Board of Directors meeting on 26 April 2024". https://cbr.ru/eng/press/event/?id=18648. Accessed April 29 2024.

[27] Kommersant. "Титов о повышении ставки: ЦБ реагирует на сиюминутные вызовы, но не выстраивает условия для развития" ("Titov on raising rates: The Central Bank responds to immediate challenges, but does not create conditions for development"). https://www.kommersant.ru/doc/6222705. Accessed February 20 2024.

China not ready to bail Russia out

Since Russia began to experience economic difficulties due to Western sanctions, there have been many expectations that China will come to Russia's aid and replace the West as Russia's main economic partner. That is happening - but not to the advantage of Russia as Putin probably expected.

First, China is visibly not interested in investing in Russia. At the time when Western investments stopped, and foreign companies began a massive exit from Russia after Putin's full-scale invasion of Ukraine, Russia had high hopes that investors from China and the Global South would replace fleeing Western companies. This hasn't happened. Since February 2022, there has been zero (!) investment entries into Russia from investors representing China, India, and other major economies of the Global South. Their role was minimal even before – the Russian Central Bank ceased publishing the statistics on foreign direct investment in Russia since February 2022, but as of early 2022, total accumulated Chinese FDI stock in Russia was just $3,3 billion dollars[28]- a negligible amount, mostly concentrated in just two projects aimed at exports of LNG to China - Yamal LNG and Arctic LNG-2. (Total accumulated Indian FDI stock in Russia was just $600 million dollars.)

In 2022, Russian Minister for Development of the Far East and Arctic Alexey Chekunkov stated in an interview: "If you count those projects in Russia where large Chinese investors actually participated, then the fingers of one hand will suffice. For an economy with a market capitalisation of $20 trillion and banking system assets of $50 trillion, this is not enough"[29]. The situation hasn't changed since, and clearly won't in the future. Chinese investors consider Russia toxic due to sanctions, its market - small, with a new wartime draconian regulatory regime for foreign investors and capital controls - disadvantageous. As the past two years show, Russia shouldn't count on investments from the countries of the Global South.

Second, China is fundamentally not interested in opening up its markets to Russia, and in the emergence of Russia as a notable competitor in the international markets for manufactured goods. A few months ago, such a political heavyweight as Moscow Mayor Sergey Sobyanin raised eyebrows by publicly admitting at a conference that Eastern countries (including China) are "waging an economic war" against Russia, no less. "Eastern markets, we must understand that they are even tougher. There is already a serious war going on with us there, an economic war. No one wants to give technology - neither in the field of mechanical engineering, nor in the field of aircraft manufacturing, nor in the field of microelectronics. Nobody is going to. Moreover, they openly tell us: if you want to get some technology, buy the entire product. We say: no, we need, at best, components that we will replace soon. They tell us: we understand this, so we are not going to do it, at least not at normal prices. Here's double the price, please," Sobyanin said. He also noted that the authorities of Asian countries are actively providing their companies with various preferences, "giving their producers, in fact, dumping"[30].

[28] Central Bank of Russia. "Прямые инвестиции в Российскую Федерацию. Остатки по инструментам и странам-партнерам" ("Direct investments in the Russian Federation. Balances by instruments and partner countries"). https://www.cbr.ru/vfs/statistics/credit_statistics/direct_investment/dir-inv_in_country_1.xlsx. Accessed February 20 2024.

[29] Kommersant. "«Главный вызов — найти внутренние ресурсы»
Алексей Чекунков о перспективах нового разворота на восток" (""The main challenge is to find internal resources". Alexey Chekunkov on the prospects of a new pivot to the East"). https://www.kommersant.ru/doc/5458995. Accessed February 20 2024.

[30] RBC. "Собянин заявил об экономической войне с восточными странами" ("Sobyanin spoke about an economic war with Eastern countries"). https://www.rbc.ru/economics/28/09/2023/651555689a79471cf509e712. Accessed February 20 2024.

One major example of how this works in 2023 was China kicking Russia out of a joint CR929 project aimed at building a widebody passenger jet to compete with aircraft produced by Boeing and Airbus. After over a decade of maintaining a cooperation "facade" and little progress, China finally decided that it would proceed with its widebody aircraft program without Russia[31]. We predicted this in our past publication "Ambitions Dashed: Why Sino-Russian Economic Cooperation Is Not Working"[32], basically predicting a broader picture of Sino-Russian cooperation remaining limited to some very primitive trade patterns, and not evolving into a truly sustainable partnership, contrary to what many in the West expected.

In late December 2023, Russia's First Deputy PM Andrey Belousov - Putin's former economic aide and one of Putin's key trusted figures in dirigiste economic policies - broadly admitted in an interview that China is not interested in providing access to its market for Russian goods: "We must clearly understand that no one is waiting for us in the markets of friendly countries [including China]. These markets are occupied either by the goods of friendly countries themselves, or by their competitors - the same European goods"[33].

A stark illustration of a lack of access to Chinese and other Global South countries markets is the fresh data from the Russian Ministry of Industry and Trade, which in early 2024 has informed that Russian non-mineral and non-energy exports had fallen in 2023 as compared to 2022 by 23%, from $190,4 to $146,3 billion[34].

Third, trade with China is significantly less advantageous for Russia than the lost trade with Western countries appeared to be. To begin with, there are significantly higher costs of logistics in trading with China, combined with underdeveloped infrastructure and low rail and road throughput capacity between Russia with China. Expanding this infrastructure will require additional hundreds of billions of dollars. Another factor is the structural imbalance in mutual trade: nearly all of the Russian exports to China are raw materials, usually supplied at significant discounts, whereas China mostly supplies Russia with high added-value finished products. Increasing volumes and prices of goods imported from China nearly offset the value of Russian natural resources exports to this country: while in 2022 the value of Russian exports to China increased the value of Chinese exports to Russia by 50%, in 2023, the figures nearly levelled off, and Russian exports exceeded imports from China only by $19 billion, of 16%[35]. The gap is closing in and soon Russia may face a near-zero or even negative trade balance with China.

[31] The Air Current. "Comac drops Russia from CR929 program". https://theaircurrent.com/aircraft-development/comac-appears-to-drop-russia-from-cr929-branding/. Accessed February 20 2024.

[32] Wilfried Martens Centre for European Studies. "Ambitions Dashed: Why Sino-Russian Economic Cooperation Is Not Working", by Vladimir Milov, November 2021. https://www.martenscentre.eu/publication/ambitions-dashed-why-sino-russian-economic-cooperation-is-not-working/. Accessed February 20 2024.

[33] Kommersant. "«Думаю, точку равновесия мы найдем». Андрей Белоусов о том, как экономика РФ адаптируется к новым условиям" (""I think we will find a balance point". Andrey Belousov on how the Russian economy is adapting to new conditions"). https://www.kommersant.ru/doc/6428575. Accessed February 20 2024.

[34] Kommersant. "Несырьевой экспорт упал почти на четверть" ("Non-mineral exports fell by almost a quarter"). https://www.kommersant.ru/doc/6510204. Accessed February 23 2024.

[35] RBC. "Что Россия продавала Китаю в 2023 году и что покупала у него" ("What Russia sold to China in 2023 and what it bought from it"). https://www.rbc.ru/economics/24/01/2024/65af9e809a79472aaca18347. Accessed February 20 2024.

Just imports of Chinese cars by Russia reached $11,5 billion in 2023[36] - almost twice exceeding the value of gas exports to China via the much-celebrated “Power of Siberia” gas pipeline ($6,4 billion)[37]. When Putin boasted in a recent interview to Tucker Carlson about the “balanced” nature of Sino-Russian trade, he was simply lying: “According to our figures, our bilateral trade with China totals already 230 billion, and the Chinese statistics says it is 240 billion dollars. Our trade is well-balanced, mutually complementary in high-tech, energy, scientific research, and development. It is very balanced”[38].

Sino-Russian trade at the moment is anything but “balanced”. The discounts on the Russian mineral resources exported to China are nothing short of shocking. According to above-mentioned data on Russian revenues from pipeline gas exports to China, the average price of gas supplies to China via the “Power of Siberia” pipeline in 2023 was $284 per thousand cubic meters (tcm), against $493/tcm average price of LNG imports in Eastern Asia (JKM, Japan Korea Marker), or average 2023 price of $545/tcm at TTF gas hub in the Netherlands.

Discounts for Russian oil are no less impressive. According to the Gaidar Institute, total discount for Russian crude oil exporters supplying oil to China as compared to China’s oil purchase price from other suppliers amounted to $9 billion from March 2022 through October 2023[39].

At the same time, the price of goods imported from China are skyrocketing. A switch to near-total imports of Chinese cars - which currently amount to over 90% of Russian car imports and about two-thirds of Russian domestic car sales[40]- have resulted in Russian domestic average sales price growth for imported cars by 75% in February 2024 as compared to December 2021[41]. The same happens with the imports of industrial goods substituting lost Western supplies. For instance, Russian gas company Novatek has reported a 17% (or nearly $4bn) increase in capital expenditures for the Arctic LNG-2 project due to a switch from U.S.-manufactured Baker Hughes power turbines to those produced in China by Shanghai Electric[42]. A similar increase of costs (and loss of productivity) due to a switch from Western to Chinese technologies and equipment can be widely expected across various Russian industries.

At the end of the day, Russia is learning the hard way that China - much as other countries of the Global South - is not interested in being Russia’s donor as the West was in the past 30-40 years: donor in terms of capital, technology, skills, supply of critical component parts for the industry. China is only interested in Russia economically as a supplier of cheap raw materials with sizeable discounts, as a market for Chinese finished products sold at a premium, and not interested in investing in Russia or seeing Russia emerging as a competitor at international markets of manufactured goods. The potential of Sino-Russian economic cooperation as a possible alternative to the West is grossly overestimated by many analysts.

[36] RBC. “Экспорт китайских авто в Россию вырос более чем в семь раз” (“Chinese car exports to Russia have grown more than sevenfold”). https://www.rbc.ru/economics/20/01/2024/65abc82f9a7947799922f7d7. Accessed February 20 2024.

[37] TASS. “Стоимость поставок газа по трубопроводу из России в Китай увеличилась на 61,7% за год” (“The cost of gas supplies via pipeline from Russia to China increased by 61,7% over the year”). https://tass.ru/ekonomika/19774519. Accessed February 20 2024.

[38] Kremlin. Vladimir Putin’s interview to Tucker Carlson. http://en.kremlin.ru/events/president/news/73411. Accessed February 20 2024.

[39] Gaidar Institute. “Предварительные итоги внешней торговли России в 2023 году. Товарооборот с Китаем” (“Preliminary results of Russian foreign trade in 2023. Trade turnover with China”). https://www.iep.ru/ru/monitoring/predvaritelnye-itogi-vneshney-torgovli-rossii-v-2023-godu-tovarooborot-s-kitaem.html. Accessed February 20 2024.

[40] RIA Novosti. “Доля Китая в импорте автомобилей за восемь месяцев составила 92 процента” (“China’s share of car imports was 92 percent in eight months”). https://ria.ru/20230919/avtomobili-1897124836.html. Accessed February 20 2024.

[41] Rosstat. “Средние потребительские цены” (“Average consumer prices”). https://rosstat.gov.ru/statistics/price. Accessed February 20 2024.

[42] Kommersant. “«Арктик СПГ-2» дорожает” (“Arctic LNG-2 is becoming more expensive”). https://www.kommersant.ru/doc/6068141. Accessed February 20 2024.

Investment

One of the key obstacles to developing a "new economic model" that would secure Russia's recovery after decoupling from the West is the total lack of understanding where the investment will be coming from. Russia is no longer an interesting destination for international investors; domestic sources of capital are constrained by a number of factors – including growth-prohibitive interest rates and lack of access to Western financial markets which usually served as a source of long-maturity financing. Companies' own profits are the key source of financing fixed investment – according to Rosstat, they contributed 56% to the total fixed investment in 2023, whereas bank loans – below 9%, and foreign loans and direct investment – only 0,6%. Remarkably, the second-largest source of fixed investment financing are state funds – 20[43].

That model is clearly unsustainable, because budget funds are finite, and companies' profits will continue to be under pressure – both due to Western sanctions, as well as to the government's tax increase drive, fuelled by growing budget spending needs. It is also worth mentioning that a significant - and probably dominant - direction of fixed investments at the moment are not expansion-aimed productive investments, but rather forced "replacement" investments - when Western machinery is simply being replaced with Chinese or supplied by other producers from the Global South. Such "replacement" investments are made because Western equipment can't be serviced, and they do not lead to output expansion - but simply preservation. First Deputy Prime Minister Andrey Belousov estimated only 30% of the current fixed in-vestments to be "productive" investments, and forced "replacement" investments - to be as high as 70%[44].

Generally, even a quick glance at a breakdown of Russian fixed investment growth in 2023 clearly shows that it is heavily dominated by war-driven sectors and state financing, whereas private investment growth is modest at best. Given the looming scarcity of budget funds, and the government's intention to increase taxes and thus curb corporate profits, it becomes evident that Russia currently lacks a sustainable investment model for its economy.

Table 3. Breakdown of fixed investment in 2023[45]

	Growth after 9 months 2023, % (compared to 9 months of 2022)
"Finished metal products other than machinery and equipment" - production of weapons and ammunition	85,5 %
Railroad transport	54,5 %
State administration and military security	37,0 %
Extractive industries	5,5 %
Construction	5,0 %
Clothes production	2,7 %
Pharmaceuticals production	1,6 %
Food production	0,9 %
Agriculture	-5,4 %

[43] Rosstat. "Социально-экономическое положение России, январь-февраль 2024 года" ("Socio-economic situation of Russia, January-February 2024"). https://rosstat.gov.ru/storage/mediabank/osn-02-2024.pdf, page 107. Accessed April 29 2024.

[44] Kommersant. "«Думаю, точку равновесия мы найдем». Андрей Белоусов о том, как экономика РФ адаптируется к новым условиям" (""I think we will find a balance point". Andrey Belousov on how the Russian economy is adapting to new conditions"). https://www.kommersant.ru/doc/6428575. Accessed February 20 2024.

[45] Source: Rosstat

Import substitution not truly working

Another related issue is the lack of success in import substitution and replacement of lost Western products and intermediary goods with domestic production. Even the top Russian political leadership acknowledges this: speaking in Tomsk in October 2023, Nikolay Patrushev, Russia's Secretary of the National Security Council - and the effective chief of Putin's wartime cabinet - has effectively admitted that import substitution is not working in such important areas as manufacturing of heavy machinery, pharmaceuticals, electronics, specialized software, scientific and laboratory equipment[46].

A quick glance of output dynamics of the sectors potentially open for import substitution - due to heavy loss of Western supplies - shows that growth here has been modest at best, as shown in the table below. Most sectors failed to substantially develop domestic production replacing lost imports - the key illustration here is the carmaker industry, which only managed to capture about a third of the Russian car market, giving up two-thirds to imported Chinese cars - despite the latter being quite expensive, as explained above.

Table 4. Output growth in selected sectors in 2022-2023[46]

	Output growth, 2023 compared to 2021
Pharmaceuticals	10,7 %
Food	6,3 %
Clothing	6,3 %
Drinks	4,5 %
Motor vehicles	-37,2 %

Lack of investment sources and access to financing plays a role here; other factors are:

- Lack of sufficient scale of the domestic market to ensure viability of Russian-made products, with simultaneous lack of access to non-Western markets;
- Lack of technologies and skills;
- Negative impact of Soviet and post-Soviet manufacturing culture legacy, which lacks client orientation and impairs the development of internationally competitive products;
- Corruption and monopolism, which discourage successful innovations and improvement of manufacturing culture.

[46] VTomske.ru. “Продолжаем зависеть от импорта: Патрушев на совещании в Томске рассказал о проблемах технологического суверенитета РФ” (“Continued dependence on imports: Patrushev at a meeting in Tomsk spoke about the problems of technological sovereignty of Russia”). https://news.vtomske.ru/news/201158-prodoljaem-zaviset-ot-importa-patrushev-na-soveshchanii-v-tomske-rasskazal-o-problemah-tehnologicheskogo-suvereniteta-rf. Accessed February 23 2024.

[47]Source: Rosstat

An import substitution survey carried out by the Russian Union of Industrialists and Entrepreneurs, as published by Kommersant in November 2023[48], shows that 74% of surveyed entrepreneurs cite lack of competencies and scientific and technical base as a major obstacle for import substitution; more than half note insufficient demand from Russian companies to achieve economies of scale. The Russian market's limited size is a key obstacle for the development of manufacturing of sophisticated Russian-made products; as noted above, access to the markets of China and other countries of the Global South remains a dream, Russian non-mineral exports has fallen sharply as a result of decoupling from the West.

In these conditions, it is very hard to imagine that Russian import substitution will be successful in the near future - given the fact that all the above-listed fundamental obstacles remain. What we see instead is a replacement of Western products and technologies with those imported from China and other countries of the Global South - which often tend to be significantly more expensive, and of poorer quality.

[48] Kommersant. "Импорт прибавил в дружественности" ("Imports gained in friendliness"). https://www.kommersant.ru/doc/6350248. Accessed February 23 2024.

A "military economy"?

There's been much speculation that Putin is somehow successfully transforming Russia into a "military economy", whatever that means. Some analysts suggest that this may be some kind of new economic model that would allow Russian economy to sustain itself in the face of the Western sanctions and isolation.

First, let's be clear with terminology here. The correct definition of a full-scale, Soviet-style "military economy" probably would mean a shift to the system where private enterprises will receive mandatory "mobilisation plans", as factories maintained in the Soviet times (which has also contributed to the ineffectiveness of the Soviet economy and subsequent collapse of the Soviet Union). Companies will then be forced to maintain production capacities required for wartime needs.

Nothing of that sort is happening in Russia - at least to a major extent. What we see is an increase in military spending to 6% GDP, up from pre-war level of below 3% GDP. That's a very significant shift, but that's still not a full-scale "military economy" - the other over 90% of the GDP remains not directly related to the war. Industries directly related to wartime production - the "electronic and optical products", "finished metal products", and "other vehicles and equipment" - employ just about 1,5 million people, which is just 2% of the total Russian workforce. The total number of employees of sectors directly or indirectly related to military needs, according to the author's estimate, is no more than 5-7 million people - or below 10% of the total Russian workforce. The share of these military-related sectors in total industrial output in 2023 was just 10,5%[49].

This is insufficient to guarantee a "new military-focused economic model" for Russia. The remaining, non-military part of the economy - which remains heavily dominant with well over 90% contribution to GDP - also has to run on something.

The other important element is that Russian military-related industries solely run on government funding, and are barely able to manufacture civil competitive products that can sustain their finances. While Western military hardware manufacturers also produce a sizeable share of competitive civilian products, Russian military producers mostly don't: there's a near-zero convergence between military and civilian production. It means that Russia's "military economy" as discussed today can only sustain itself while there are government funds available for the procurement of weapons, ammunition, and other military-related products. Scarcity of state funds - which is already on the horizon - puts the sustainability of that model in question.

Previously, Russian military industries earned a significant amount of revenue from arms exports, which supported the industry's sustainability. In 2021, the total revenues from Russia's arms exports totalled nearly $15 billion; however, since then, the figure has sharply dropped, probably by two thirds, under pessimistic estimates (Russia stopped disclosing the actual arms exports revenues numbers)[50].

[49] Rosstat. "Социально-экономическое положение России, 2023" ("Socio-economic situation of Russia, 2023"). https://rosstat.gov.ru/storage/mediabank/osn-12-2023.pdf, pages 29, 219. Accessed February 20 2024.

[50] Foreign Policy. "Russia's Boom Business Goes Bust. Moscow's arms exports have fallen to levels not seen since the Soviet Union's collapse". https://foreignpolicy.com/2023/05/03/russia-arms-sales-weapons-exports-worldwide-ukraine-war/. Accessed February 23 2024.

India, Russia's main arms buyer, is showing signs of larger-scale diversification of weapons production and supplies, drifting towards larger defence cooperation with the West[51].Significant shrinking of arms exports revenues further increases vulnerability of Russian military industries.

Lack of convergence with civilian markets also exacerbates the challenge of a lack of multiplying effect from military investments and spending: in the words of Russian economist Sergei Guriev, "weapons and munitions don't contribute to quality of life, don't contribute to future economic growth. They are shipped to Ukraine, where they are destroyed"[52]. Other goods and services further contribute to economic development, while military hardware immediately spent at the battlefield has zero multiplier in this regard. This is another factor that allows to characterise Putin's current "military" economic model as unsustainable.

To sum up, the discussion about Russia transforming into a "military" economy exaggerates the situation. Indeed, the military-related portion of the Russian economy has significantly expanded due to aggression against Ukraine, but it is insufficient to keep the whole economy afloat, and the model of Russian military industry based solely on state spending is not sustainable in the longer run.

There are also signs that the Russian military production may be peaking: while in mid-2023 sectors like "finished metal products" (production of weapons and ammunition) demonstrated 30-40% year-on-year output growth, in the end of 2023 - early 2024, the growth slipped down to just 8-13% in annual terms[53]. While rebounding later, growth of sophisticated military production is capped by Russia's lack of ability to produce high precision machinery required for weapons production - which it still has to import. Some of the imports of military-related machinery tools came from China[54], but China arguably doesn't have the ability to produce all the necessary high-precision equipment, which is why Russia in 2023 went to great lengths to clandestinely import the necessary machinery tools from Taiwan[55]. The Taiwanese government has already introduced restrictive measures aimed at shutting down these supply chains after the reports of Russia importing critical military-related machinery tools from Taiwan have surfaced. This means that Russia is vulnerable in terms of dependence on imports of high-precision machinery for military industry from Western democracies.

Therefore, there's not much space for the Russian military industry to expand production: the necessary machinery for new production lines may be lacking, while Russian military factories are already working near full capacity, mostly in three shifts[56]. Peaking production of weapons and ammunition - if weaker growth in this industry proves to be persistent - may have significant deterring impact on Russia's ability to expand its military operations in Ukraine.

[51] Reuters. "India pivots away from Russian arms, but will retain strong ties". https://www.reuters.com/world/india/india-pivots-away-russian-arms-will-retain-strong-ties-2024-01-28/. Accessed February 23 2024.

[52] Business Insider. "How Russia has avoided bankrupting itself after 2 years of waging war in Ukraine". https://www.businessinsider.com/russia-economy-how-moscow-pays-war-economy-afloat-sanctions-ukraine-2024-2. Accessed February 23 2024.

[53] Rosstat. "Социально-экономическое положение России, 2023" ("Socio-economic situation of Russia, 2023"). https://rosstat.gov.ru/storage/mediabank/osn-12-2023.pdf, page 28. Accessed February 24 2024.

[54] The Financial Times. "China's advanced machine tool exports to Russia soar after Ukraine invasion". https://www.ft.com/content/d16c688d-9579-4f1d-a84f-ca29ca2f0bc0. Accessed February 24 2024.

[55] The Washington Post. "Precision equipment for Russian arms makers came from U.S.-allied Taiwan". https://www.washingtonpost.com/investigations/2024/02/01/taiwan-russia-sanctions-cnc/. Accessed February 24 2024.

[56] RIA Novosti. "Предприятия ОПК работают в две-три смены, заявил Путин" ("Defense industry enterprises work in two or three shifts, Putin said"). https://ria.ru/20230616/opk-1878714182.html. Accessed April 29 2024.

How does the economic situation impact Russian population?

The Russian population has mostly been affected by raging inflation - which remains high even despite the Central Bank's hardline monetary policies and a sharp rise in interest rates. As of end-April 2024, annualised inflation remained at a level of over 7,8%, higher than in end-2023[57]. The official consumer prices index has grown by about a quarter since the beginning of Putin's full-scale invasion of Ukraine, but the actual growth in prices for basic consumer goods seems to be substantially higher: according to the Romir consumer research company, which regularly tracks the price index for fast-moving consumer goods (FMCG), in April 2024, FMCG price index has nearly doubled as compared to February 2022 - prices for basic goods have doubled in two years[58].

Inflation is neutralising the government's entire ability to maintain proper indexation of wages and pensions, which are barely catching up. In 2023, real pensions growth was just 3,3% year-on-year, sliding into negative territory in the fourth quarter of 2023 (-1,2%) and first quarter of 2024 (-0,1%). In 2024, the government plans indexation of pensions only by 7,5%, which is below current annualised inflation. Real wages are doing better - in 2023, they have increased by 7,6% as opposed to just 0,3% in 2022. But this picture is heavily distorted by military industries, where nominal wage growth has reached as high as 20-25% year-on-year in 2023, compared to much modest growth in other sectors, barely catching up with inflation[59].

Table 5. Nominal wages growth by sector in 2023

	Growth in 2023, % (compared to 2022)
"Finished metal products other than machinery and equipment" - production of weapons and ammunition	23,8 %
"Other transport facilities and equipment" - military aircraft, tanks, and armoured vehicles	22,1 %
"Computers, electronic and optical products" - radar devices, radio electronics	21,7 %
State administration and military security	15,4 %
Agriculture	13,3 %
Construction	13,2 %
Wholesale and retail trade	12,8 %
Telecommunications	12,7 %
Education	12,3 %
Health care	11,4 %
Extractive industries	10,3 %

Source: Rosstat

[57] Interfax. "Инфляция в РФ с 15 по 22 апреля составила 0,08%, в годовом выражении осталась чуть выше 7,8%" ("Inflation in the Russian Federation from April 15 to April 22 amounted to 0,08%, in annual terms it remained slightly above 7,8%"). https://www.interfax.ru/business/957608. Ac-cessed April 29 2024.

[58] Romir. "Дефлятор FMCG усилил рост" ("FMCG deflator accelerated growth"). https://romir.ru/press/deflyator-fmcg-usilil-rost. Accessed April 2024.

[59] Rosstat. "Социально-экономическое положение России, 2023" ("Socio-economic situation of Russia, 2023"). https://rosstat.gov.ru/storage/mediabank/osn-12-2023.pdf, pages 198-201, 208. Ac-cessed February 24 2024.

Even this growth in wages hardly - if at all - matches the real price increase in the FMCG sector as described above.

Domestic consumption has rebounded in 2023 by 6,4%, but still ended up 0,5% below the pre-war level of 2021[60]. A dangerous trend in the recovery of domestic consumption is that it was significantly fuelled not just by wages and pensions growth, but by reckless household credit expansion, often beyond reasonable credit burden limits. Since 2021, the total household loan portfolio has expanded by 28%, from 25 trillion to 32 trillion rubles[61], and the Russian Central Bank notes the significant share of Russians already heavily leveraged with debt among new borrowers[62].

Russian authorities love to boast about historically low unemployment - which is indeed at impressive lows, down to 2,3% in December 2023. However, this gives little reason for optimism. First, low unemployment is the consequence of the scarcity of skilled workforce as a result of the war, mobilisation, and an exodus of qualified personnel from the country. This factor is significantly holding back output and is one of the most pro-inflationary factors in the Russian economy as of now. Second, while inflation is eating up the lion's share of wage indexation in most sectors - which is the main problem regarding standards of living - low unemployment doesn't add much to increase consumer purchasing power.

Third, paradoxically, on top of a shortage of skilled labour, Russia has massive hidden unemployment - in times of crises, the Russian government usually presses employers not to lay people off, but to send them into various forms of temporary effective unemployment which disguises itself with other names (unpaid leave, down-time, or part-time working week). The total number of employees on unpaid leave, downtime, or part-time working week in the third quarter of 2023 has reached over 4,6 million people, or over 6% of the total workforce, up by nearly 20% since the beginning of the full-scale invasion of Ukraine[63]. About 70% of those affected by hidden unemployment are on unpaid leave, which has, in fact, little difference with being laid off. The labour force affected by hidden unemployment needs significant retraining to be able to obtain skills required in areas hit by skilled labour shortage (e.g., a carmaker factory worker can't immediately take up a job as an IT specialist), so an excessive workforce in certain sectors is not helpful to compensate for labour shortage in others. If official and hidden unemployment numbers are added up, total unemployment nears 8,5%, which is significantly higher than the official estimates.

In general, Russian authorities have not been able to protect the Russian population from the adverse effects of economic decoupling from the West. Inflation continues to devalue wages and pensions, and their planned indexation remains limited due to Putin's priority focus on financing the war (for 2024, the Russian budget plans only 9,8% indexation of salaries and 7,5% of pensions, which is barely enough to compensate for official figures consumer price growth). Neither more aggressive wage indexation in military-related industries, nor low nominal unemployment are able to significantly improve living standards at the nationwide level.

[60] Rosstat. "Социально-экономическое положение России, 2023" ("Socio-economic situation of Russia, 2023"). https://rosstat.gov.ru/storage/mediabank/osn-12-2023.pdf, page 103. Accessed February 24 2024.

[61] Central Bank of Russia. "Банковский сектор. Аналитический обзор. Декабрь 2023" ("Banking sector. Analytical review. December 2023"). https://www.cbr.ru/Collection/Collection/File/46673/analytical_review_bs-2023-3.pdf. Accessed February 24 2024.

[62] RBC. "Россиян с тремя и более кредитами стало больше на 2,2 млн человек Какие риски это создает" ("Number of Russians with three or more loans increased by 2,2 million people. What risks does this create?"). https://www.rbc.ru/finances/30/10/2023/653f933b9a79479fa8f57149. Accessed February 24 2024.

[63] Rosstat. "Социально-экономическое положение России, январь-октябрь 2023 года" ("Socio-economic situation of Russia, January-October 2023"). https://rosstat.gov.ru/storage/mediabank/osn-10-2023.pdf, page 220. Accessed February 23 2024.

According to the Levada Center[64], the share of Russians who describe their material well-being as "everything is perfect" or "things are not so bad" is down from over 50% in 2021 to just about 25% in the second half of 2023, with the share of those saying that either "life is difficult, but you can endure it" or "it is no longer possible to tolerate our poor financial situation" is up from below 50% in 2021 to about 75% now. Questions about growing prices and insufficient wages and pensions, alongside the question about the end of the war with Ukraine, dominated the field of questions that Russians wanted to ask Vladimir Putin during his public press conference in December 2023, as per opinion polling surveys[65].

[64] Levada Center. "Цены и потребительская адаптация" ("Prices and consumer adaptation"). https://www.levada.ru/2023/09/21/tseny-i-potrebitelskaya-adaptatsiya/. Accessed February 26 2024.

[65] Levada Center. "Вопросы, которые россияне задали бы Владимиру Путину" ("Questions that Russians would ask Vladimir Putin"). https://www.levada.ru/2023/12/05/voprosy-kotorye-rossiyane-zadali-by-vladimiru-putinu/. Accessed February 26 2024.

What were the relative successes of the Russian economy?

As can be seen from the numbers above, some of the indicators that are used to characterise the Russian economy as “resilient” are irrelevant or misleading. GDP growth is not reflecting the grim situation in most of the sectors of the economy apart from military industries; low unemployment doesn’t say anything about the wellbeing of everyday Russians; stabilisation of the ruble exchange rate is temporary and only possible due to tight monetary policies and draconian capital controls that hurt the business environment. Russia still has significant financial reserves, but they are notably shrinking, and this process will accelerate in 2024.

However, in some areas, Russian authorities and businesses have been relatively successful in avoiding the catastrophic scenarios that were expected. First, Russia has been more or less successfully evading the G7 oil price cap set at $60 per barrel throughout 2023. Since July 2023, the average monthly price for Urals, Russia’s main export crude oil, was above $60 per barrel, even reaching the average level of above $80 per barrel in September-October 2023[66]. Since then, Western governments have put additional pressure on international shippers, traders, and insurers to make sure the G7 oil price cap is respected, after which the discounts for Urals crude grew again; however, Urals is being sold above $70 per barrel as of end-April 2024[67].

According to the author’s estimate based on correlation between oil price levels and monthly oil & gas budget revenues, the Russian budget has earned around RUR 3 trillion (over 30 billion Euros) of additional oil export revenue in 2023 as opposed to the amount of revenues that would have been earned if the G7 oil price cap was fully respected. That is equal to about two-thirds of the remaining cash in the liquidity portion of the National Wealth Fund. Should the G7 oil price cap have been properly enforced, it would be fair to say that Russia by now would have spent most of the remaining cash reserves and would be running dangerously low on cash.

Second, Russia has so far avoided a full-scale banking crisis, which was widely expected. Russian banks have shown record profits in 2023 – RUR 3,3 trillion, and pessimistic forecasts that toxic assets would weigh in due to borrowers’ economic difficulties haven’t materialised. This was achieved, arguably, by the Central Bank’s deliberate policy of allowing banks to stem extra profit margins from domestic clients to a previously unseen scale. According to the Central Bank, average net interest margin for the Russian banking sector has increased from 2,9% in the first half of 2022 to 4,8% by end-2023; net interest income has increased in 2023 by 43% compared to 2022, and by 47% compared to 2021, net commission income – by 20% and 27% respectively[68].

[66] Russian Ministry of Finance. “О средней цене на нефть марки Urals” (“On the average Urals oil price”). https://minfin.gov.ru/ru/press-center/?id_4=38736-o_srednei_tsene_na_neft_marki_urals. Accessed February 26 2024.

[67] Interfax. “Дисконты нефти Urals в апреле остаются примерно на уровне марта” (“Urals oil discounts in April remain approximately at the level of March”). https://www.interfax.ru/business/958204. Accessed April 2024.

[68] Central Bank of Russia. “Результаты банковского сектора за 2023 год” (“Banking sector results for 2023”). https://www.cbr.ru/Collection/Collection/File/47807/presentation_20240130.pdf. Accessed February 26 2024.

This is, effectively, another additional tax imposed on the economy – a tax for the "survival of the banking sector" of sorts. When being asked about all these extra banking profits, Central Bank chairman Elvira Nabiullina said in a recent interview that extra profits "allow banks to increase capital. They have practically no other sources, external sources are closed, and profit is the main source of capital"[69]. So, basically, the Central Bank closes its eyes to extra indirect taxation of the economy by the banking sector, to create a financial buffer securing the banks during crisis. Needless to say, all this extra spending by the real sector of the economy, resulting in higher bank margins and commissions, is an additional factor impeding investment and development of the real sector – just for the sake of guaranteeing the survival of the banks. According to recent surveys of Russian businesses, expensive credit – alongside a shortage of skilled labour – are the two most serious problems currently impeding economic development, far above any other challenges[70].

[69] RBC. "Эльвира Набиуллина - РБК: «Есть искушение думать, что нам море по колено»" ("Elvira Nabiullina to RBC: "There is a temptation to think that the sea is knee-deep for us"). https://www.rbc.ru/interview/finances/25/12/2023/658588589a79477f58d30b61. Accessed February 26 2024.

[70] Delovaya Rossiya. "Дорогие кредиты и кадры – главные бизнес-вызовы 2023 г. по мнению генсовета «Деловой России»" ("Expensive loans and labour force are the main business challenges of 2023, according to the General Council of Business Russia"). https://deloros.ru/press-centr/slovo-gensoveta/dorogie-kredity-i-kadry-glavnye-biznes-vyzovy-2023-g-po-mneniyu-gensoveta-delovoy-rossii-/. Accessed February 26 2024.

Conclusions and policy recommendations

A deeper look into the real Russian economic situation – beyond just surface figures of GDP dynamics or unemployment – shows that the economy is not so much "resilient", but rather sinks slowly under the pressure from sanctions and decoupling from the West. A new, post-Western model of development has not been found, and is not visible in sight. The economy is kept afloat by the remaining resources, but these are scarce and finite, and the growth is concentrated in a narrow set of sectors – primarily military industries – which are heavily reliant on budget funding that may become problematic quite soon. Areas of outsized growth and profits – military industries, construction, banks – all have major vulnerabilities, and their dynamics are not sustainable in a longer run.

Economic relations with China are not as advantageous and are far less profitable than ties with the West were: China only buys Russian natural resources with discounts, sells its finished products at a premium (which also contributes to inflation and weakening of the ruble), and is not interested in Russia's emergence as a competitor in manufacturing goods, not providing Russia with investment or technologies. The ruble has fundamental weaknesses, inflation still wasn't brought under control, even despite the toughest monetary policy in years. At the same time, high-interest rates hurt economic recovery – alongside looming tax hikes and heavy capital controls for exporters. Nearly all the existing trends are pro-inflationary – budget deficit spending, high costs of trading with Asia, shortage of skilled workforce, and prospects for further devaluation of ruble.

Despite business sentiment at the moment being still somewhat upbeat, it is quite realistic to expect that, in the coming months and years, more and more Russian businesses may become disillusioned with the "new economic model" – which is basically zeroing out their profit margins and creates persistent risks – and will be curtailing business plans. At the moment, most of the optimism is driven by the government's assurances that the economy had "passed the worst point and is on the road to recovery" – but so many factors are pointing out that, instead, it was rather a blip than the light at the end of the tunnel, and after withstanding the first shock, Russian economy is confronted by multiple progressing challenges, with no clear policy answers in sight, and shrinking capabilities of the government to support the economy.

Unlike the late USSR, modern-day Russia doesn't have the ability to significantly increase borrowing to sustain its economy. China and other countries of the Global South are clearly not interested in bailing Russia out – major loans to Russia are not even under discussion, and China has its own difficulties with cooling domestic economy. Putin can hypothetically switch to eased monetary policy and monetary emission – but this would mean a complete turnaround from current tight approach taken by the Central Bank, and risks spiralling inflation out of control. Arguably, fear of this scenario is most likely the reason why Putin supports Central Bank's tight monetary policies, despite major setbacks for economic recovery and heavy pressure from various lobbyists who advise monetary easing. All of these are perilous policy choices.

All this means that Western sanctions are working. Their effect is not as swift and comprehensive as was hoped for by many, but it is quite strong and progressing. There are several points of policy advice to Western political decision makers that should be outlined.

First, policy makers should switch to a nuanced analysis of Russian economic performance in detail to assess the impact of sanctions, and drop the approach based on picking just a narrow set of indicators that portray a false picture of "Russia's economic resilience". Nuanced analysis shows that the situation is, in reality, not so bright and deteriorating. Dynamics also matter more than some of the misleading current indicators – the Russian economy will get worse over time. Policymakers should be clear-eyed about the adverse effects of sanctions on the Russian economy, and not limit their analysis to superficial overview based on generalised indicators such as GDP growth.

Second, stricter enforcement of already adopted sanctions truly matters. As can be seen from the example of the poorly enforced oil price cap, Russia benefits from sanctions evasion to such extent that its available financial reserves would have been depleted by now, if not the sanctions circumvention. Significant amount of Western goods and component parts for manufacturing are imported through clandestine schemes involving Central Asian, Middle Eastern, and other countries. Although Western governments already undertake measures aimed at shutting down these sanctions evasion schemes, this work needs to be scaled up, as the use of such circumvention schemes is massive - addressing just certain individual cases won't be enough.

Third, there's much room for further phasing out of Russian exports - including such products like non-ferrous metals, LNG, nuclear fuel and services, and many others. This may deprive Russia of tens of billions of Euros of annual export revenues, significantly affecting the state budget and current accounts balance. There are many detailed recommendations on these measures, beginning from the International Working Group on Russian Sanctions (the "Yermak-McFaul group")[71]. If additional restrictions on some Russian export commodities risk to have a negative impact on certain Western economies, specific plans should be developed for a gradual phasing out of such Russian commodities and their replacement with alternative suppliers - as opposed to just kicking the can down the road.

All these three policy directions combined together have the potential to seriously exacerbate Putin's economic woes as described above and put much additional pressure on Russia's ability to continue the war against Ukraine.

[71] The International Working Group on Russian Sanctions (https://fsi.stanford.edu/working-group-sanctions). Accessed February 26 2024.

Wilfried
Martens Centre
for European Studies