BOFIT blog

A year of war has changed the Russian economy

Russian economy | 27 March 2023 | Laura Solanko

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In 2023 sanctions continue to hurt Russia's economy. Many businesses have had to adjust to using inferior-quality components or paying higher prices for traditional inputs.

In March 2022, after its illegal and brutal invasion of Ukraine, Russia was hit by a triple whammy: a financial shock, a trade shock and an uncertainty shock. Skillful actions by the central bank, hefty export revenues and vastly increased public spending cushioned the Russian economy against the impacts of a full-blown crisis. Russian businesses spared no effort in adjusting and finding alternative suppliers of components and inputs. As a result, the 2022 GDP decline of 2.1 % was milder than expected a year ago. Compared to pre-war growth forecasts, Russian economy was about 5 % smaller last year.

In 2023, however, sanctions continue to hurt Russia's economy. Many businesses have had to adjust to using inferior-quality components or paying higher prices for traditional inputs. Russia's financial markets and many sectors of the real economy must now cope without foreign partners. Some companies are shifting from high-tech to low-tech.

Oil sanctions are now fully in place after a prolonged transition. Thus, we expect export prices and volumes to remain low and net exports will no longer be able to support GDP growth. Moreover, as the war drags on, public spending and public investments will increase. The 2023 budget deficit will be much higher than the currently budgeted 2 % of GDP, but should still be manageable. As discussed in our latest BOFIT Forecast, the economic recession will persist throughout this year.

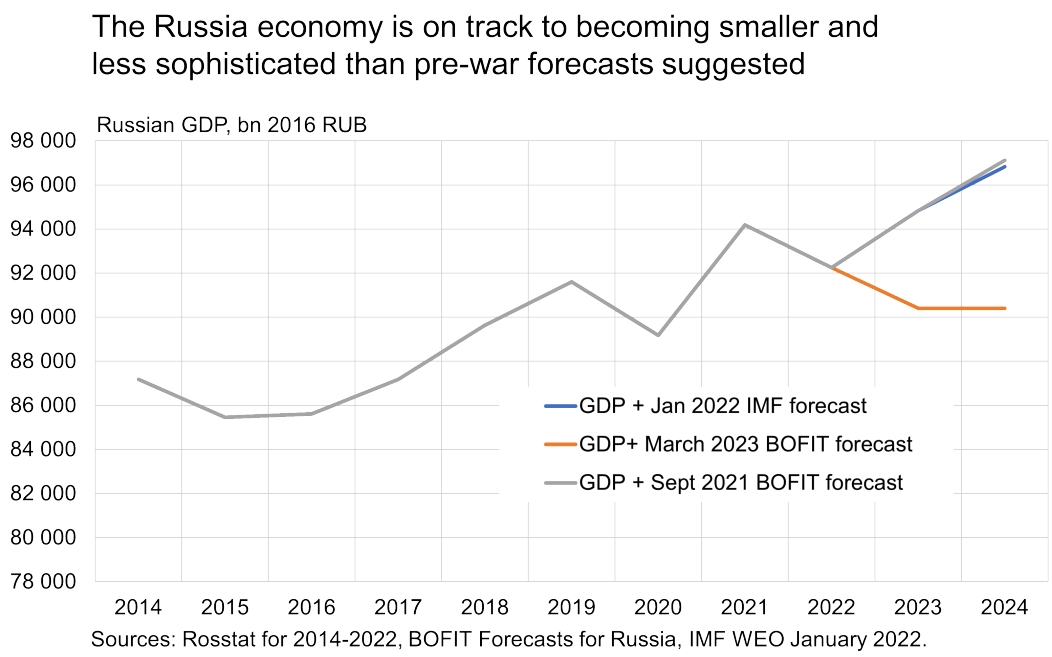
Going forward, the potential for economic recovery will be shaped by two highly volatile factors: war and Russia's fiscal sustainability.

On the surface, it might seem that the Russian economy has not been severely affected by war. In the current situation, however, it's not the headline GDP numbers that matter as they mask a significant structural overhaul of the Russian economy. During the first year of war, the Russian economy was pushed on a path of structural transformation towards a largely autarchic, state-managed economy. Import substitution and decoupling from "unfriendly countries" were placed high on the political agenda. Such policies can only succeed with huge investments in domestic production to replace lost imports, as well as the construction of new transportation links to the east and south. As resources are limited, this implies less investment in other sectors, including potentially more productive areas. The economy will move away from the technological frontier. This retreat and retrenching is referred to by some Russian economists quite illustratively as *primitivizatsia* or reverse industrialisation.

Advanced Western economies currently labelled as "unfriendly" by Russia represent over 50 % of the global economy and account for an even larger share of global research and innovation activity. As of end-2021, over 90 % of Russia's FDI stock originated in unfriendly countries. Cutting these links is a tremendous shock that will retard Russia's growth potential.

As long as the current war of attrition confrontation continues, Russia will need to invest heavily in building its military capabilities and has made supporting the war effort the primary economic policy goal. This applies not only to the military-industrial complex, but to the many sectors that support the war effort, including textiles, food and medicines. Even ignoring the fact that resources are easier to misallocate in a wartime economy, Russia is stuck ineluctably on a path to lower potential growth and a bleak economic future.

Chart 1.



The March 2023 BOFIT Forecast for Russia is available at https://www.bofit.fi/en/monitoring/forecasts-for-Russia-and-China/latest-forecast-for-russia/.

Keywords

BOFIT, economy, Russia, sanctions, war