BLOG

Why did initial estimates get Russian economic performance so wrong?

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Back in March 2022, it looked like a full-blown financial crisis was in the making in Russia. Due to unprecedented economic sanctions, the ruble was in freefall, the Russian stock market had crashed and households were rushing to withdraw their remaining bank deposits. During the early months of Russia's invasion, most economists expected the ensuing financial market shock, coupled with restrictions on foreign trade, to suppress Russian economic activity by as much as ten percent. The outcome, however, turned out to be much more benign. While economic activity as measured by GDP contracted by 5 % year-on-year in April-June, it declined much less than initially expected for 2022 overall. Did this outcome somehow demonstrate that the Russian economy was more resilient than we thought? To be succinct, no.

Assumptions about oil prices, sanctions and economic policies

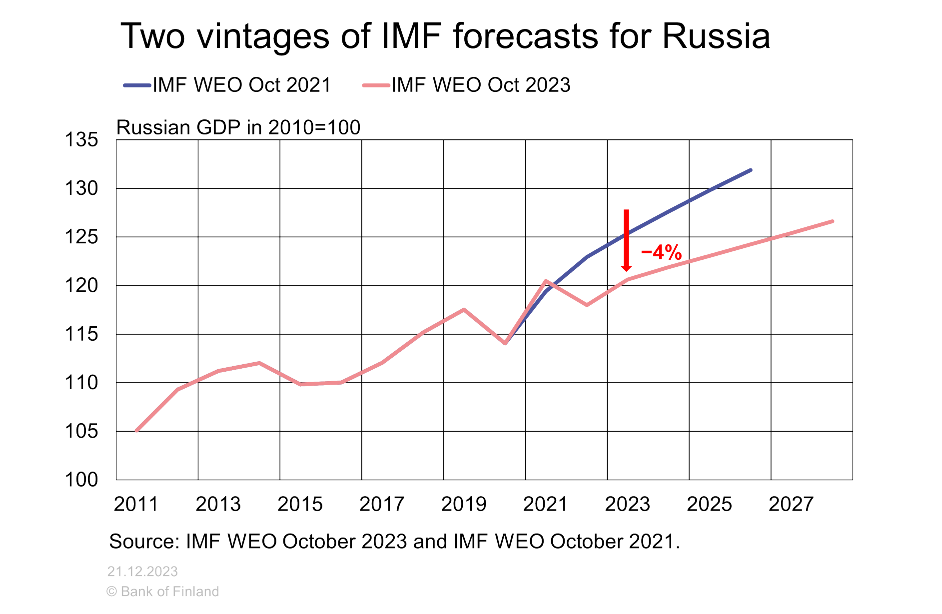
Expectations of a steep decline in economic activity were not a product of wishful thinking in the West. Almost all forecasters inside and outside of Russia foresaw a much deeper contraction, reflecting the fact that the new packages of Western sanctions and Russia's actions were unprecedented. No amount of good quality data and sophisticated modeling was sufficient to deliver precision in forecasting the effects of this unique historical confluence of events. Now, with the benefit of hindsight, we can identify factors that drove this forecasting error.

At the risk of oversimplifying, three factors that boosted Russian economic activity deserve mention: higher-than-expected oil prices, narrower-than-expected sanction regimes and the aggressiveness of Russia's fiscal expansion. These factors naturally reinforce each other. Lower oil prices and tighter sanctions obviously would limit fiscal policy. But before getting into these three factors in detail, it should be noted that, given the importance of this war to Russia's current regime, even a dramatic decline in government tax revenues was unlikely to result in cuts to war-related spending. Economic reality has a very limited effect on the policy choices of authoritarian regimes.

Russia did get lucky with respect to export and tax revenues. Global prices on energy carriers reached historic highs in 2022, partly in reaction to Russia's invasion. Even if Russia's main export, Urals blend crude, was sold at large discounts, its average export price in 2022 was higher than in 2021 (a price development that seemed improbable at the start of 2022). High export prices boosted government revenues, energy company cash flows and the ruble's exchange rate.

Most forecasters, including myself, over-anticipated the scope of emerging sanctions regimes. With the world widely condemning Russia's brutal invasion during the early days of the war, it seemed reasonable to assume that many countries would eventually support economic sanctions against Russia.[1] While wrong, this faulty assumption by no means indicated that limited sanctions would not achieve some of their desired effects. In fact, given that sanctions are currently imposed only by a small, but powerful coalition of countries, the effects are devastating. Global exports of sanctioned high-priority battlefield items to Russia are down by 40 % and exports of other sanctioned dual-use goods off by 30 % compared to pre-invasion levels (Simola, 2023).[2] Russian crude oil continues to trade at a discount, restricting government revenues to at least some extent. Tighter implementation and countering sanctions evasion could further restrict government revenue and decrease technology exports to Russia.

Chart 1.



War economy and fiscal expansion

Perhaps most importantly, we forecasters were caught flat-footed by the speed at which Russian economic policies shifted to a war footing. A fully open capital account and a

1. On March 2, 2022, 145 countries supported a UN resolution condemning Russia's brutal invasion and demanding an immediate withdrawal of Russian forces. Just five countries voted against the resolution.
2. Simola, Heli (2023): Latest developments in Russian imports of sanctioned technology products. BOFIT Policy Brief 15/2023. Available at https://publications.bof.fi/handle/10024/53179.

highly conservative fiscal stance had been the cornerstones of Russian economic policy since the 1998 financial crisis. It took a while to grasp that these policy pillars had been demolished. The government was fully prepared to resort to capital controls and unequal treatment of foreign investors to achieve a temporary freeze of financial markets. Public expenditures soared and large companies were asked to pony up ad hoc payments to the federal budget. Military industries were freed from normal labor regulations and partial mobilization was complemented with higher salaries for contract solders. From early on, subsidized bank lending to strategic sectors, SMEs and mortgages was used to support private consumption.

Going forward, these increases in war-related expenditure will continue to lift Russia's reported GDP figures. Nevertheless, a war-related economic expansion is a poor sign of resilience. Increases in production commanded by the authorities provide little evidence of an innovative, flexible response to an unexpected shock.

Indeed, Russia's recent economic performance merely shows that the invasion is of utmost importance to the current regime. In moving to support the war effort, Russia's leadership was willing to compromise on economic fundamentals such as ruble convertibility, foreign investment, price stability and non-military spending. These choices are causing the Russian economy to slowly drift away from the global economy.

The true resilience of Russia's economy will only be revealed when the war-related fiscal expansion is finally over.

Tags

Russia, growth, sanctions