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War Economy: Russia's Economic Development in 2022

by Roland Götz

After Russia's invasion of Ukraine, numerous institutes predicted a significant economic slump in Russia in 2022 due to the tightened Western sanctions. This did not materialize. As the energy sector remained almost completely exempt from sanctions until the end of 2022, Russia's economy saw a significant inflow of foreign currency. This prevented a collapse of the financial system. Statistical data show that in 2022 the war economy was strengthened at the expense of the civilian economy.

Keywords: Russian invasion of Ukraine, Russian war economy, Western sanctions regime, Russian energy exports, Russian economic growth

Wrong forecasts

Russia's economy was predicted to suffer a significant decline in output in 2022 as a result of the war against Ukraine and the tightening of Western sanctions. The forecasts ranged from an 8% decline in gross domestic product (GDP) - according to the consensus forecast of 18 Russian economic experts published by the Central Bank of Russia - to 10 percent (Bank of Finland Institute for Emerging Economies, BOFIT), 11% (World Bank) and 15-20% (Polish Economic Institute). A "classic" recession of the following kind had been expected: a sharp drop in exports causes a devaluation of the currency, a bank run and a resulting crisis of the banking system, resulting in rising unemployment, a budget deficit and increasing inflation. Signs of an emerging severe economic crisis had indeed been seen in the spring and summer of 2022 and seemed to confirm expectations. But in the fall of 2022, the forecasts had to be corrected.[1]

Russia's robust economy in 2022

The situation of Russia's national economy is presented below on the basis of publications by the Statistical Office of Russia (Rosstat), the Central Bank (Bank Rossii) and the Ministry of Finance (Minfin), as well as publications based on them, such as those of the World Bank and the International Monetary Fund.[2] Russia's territorial status in these statistics is the Russian Federation, including the Crimean Peninsula annexed in 2014.

Russia's gross domestic product (GDP) declined by 2.1% in real (inflation-adjusted) terms in 2022 compared with 2021, far less than had been predicted.

Although the federal budget showed a deficit of 2.2% of GDP, there was no crash in the ruble exchange rate: Russia's currency - after recording a brief peak in March 2022 - actually appreciated somewhat on average over the year compared with 2022. Unemployment was lower in 2022 than in 2021, with only inflation clouding the picture: consumer goods prices rose by 14% year-on-year - twice as much as in 2021. Even if the statistics are, as always, still subject to revision, there can be no doubt that Russia's economy proved quite robust in 2022 in the face of sanctions and the withdrawal of Western companies.

However, it cannot be concluded from this that the economic sanctions had no effect. They have certainly left their mark. After all, Russia's GDP was expected to grow by around 3% in 2022. The actual decline of around 2% therefore means a GDP loss of around 5%, which can be attributed to the consequences of the sanctions. There is no other way to explain why Russia's economy did not grow in a year in which global GDP rose by 3.4% and the price index for raw materials - Russia's main export goods - by 33%.

There are several explanations for the resilience of the Russian economy in 2022: A lack of imports could be temporarily replaced from stocks, and in the case of consumer goods, the population was forced to switch to domestically produced products, whereupon companies in the consumer goods industry expanded their production capacities, which in turn stimulated production in the capital goods industries. Production in the arms industry was boosted by government orders.

The central bank helped stabilize the financial situation: after the war began, it stopped the exchange of rubles into foreign currencies for a few weeks (with exceptions for business trips), thus preventing a bank run by the population. For loans to banks, it raised the key rate to 20% from 26 February 2022 to 12 April 2022 which limited demand for foreign currency. These measures prevented a devaluation of the ruble, at least in 2022.

Russia was also able to partially escape the pressure of the sanctions, which were significantly tightened by the EU, the USA and other countries in 2022, by many companies expanding economic relations not only with Russia's South Caucasian and Central Asian neighbors, but also with China, India, Turkey, Singapore and the United Arab Republics, thus finding both new sales opportunities for export goods and substitutes for failing imports. Also, by no means all companies from countries that have imposed sanctions have withdrawn their subsidiaries from Russia.

Only weak sanctioning of energy exports

Russia did not suffer a massive economic slump in 2022 primarily because it was able to export the same amount of crude oil, petroleum products and coal as in 2021, while at the same time benefiting from the global rise in prices of these and other raw materials. While some countries quickly imposed an embargo on energy imports from Russia, the EU states only partially implemented this step and delayed it because of fears of supply shortages and price increases. The U.S. banned imports of coal, petroleum, petroleum products and liquefied natural gas from Russia in March 2022. Australia, Canada and the United Kingdom ended their imports of petroleum and petroleum products from Russia in mid-2022. An EU coal embargo has been in effect since 10 August 2022.

An oil embargo prohibiting imports from Russia was decided by the EU states in June 2022 as part of the 6th sanctions package. It has applied to crude oil transported by ship since 5 December 2022, and to oil products since 5 February 2023. Bulgaria has obtained a temporary exemption for the supply of its refinery in Burgas until 2024.

Germany and Poland stopped importing crude oil via the northern arm of the Družba pipeline from Russia at the end of 2022. However, the Czech Republic and Slovakia continue to receive a mix of oil from Russia and Kazakhstan via the southern arm of the Družba pipeline and Hungary via the Turkish stream pipeline. In addition, crude oil is further processed in India, which has replaced Europe as the main market for oil from Russia, and shipped back to the EU in the form of petroleum products.

All EU and G7 countries and Australia have decreed an oil price cap, which has applied to crude oil since 5 December 2022, and to petroleum products from Russia since 5 February 2023. Shipping companies, insurance companies and other service providers for oil transport must prove compliance with this "price cap" in their contracts, but this is not subject to any audit. Price limits were initially set at $60 per barrel for crude oil, $45 per barrel for lower-grade petroleum products and $100 per barrel for high-grade petroleum products. However, countries such as China and India do not want to adhere to either the oil embargo or the price limits for crude oil and oil products and are also using a "shadow fleet" of tankers from unknown shipping companies and with unclear insurance cover for this purpose.

In fact, a regional fragmentation of the price for crude oil from Russia could be observed in December 2022: While ship deliveries from Baltic and Black Sea ports to India were at USD 58/barrel and thus complied with the oil price cap, the price of oil transported by pipeline from Eastern Siberia to China and from Russia's Pacific ports by tanker to China and India was oriented to the world market price of the reference Brent crude (named after an underwater oil field between Scotland and Norway) at USD 81-84/barrel.

The EU has imposed neither a gas embargo nor a price cap on gas delivered from Russia. Russia continues to supply Austria, Hungary and Italy via the Ukraine pipeline and Belgium, the Netherlands, France and Spain with LNG tankers. Estonia, Latvia, Lithuania, Poland, the Czech Republic and Germany were no longer supplied by Russia under pretexts and/or have renounced gas imports from Russia on their own initiative. While about one-third of EU gas imports came from Russia at the beginning of 2022, only about ten percent did so at the end of 2022.

Production of GDP

The statistics for gross value added (GVA) provide information on the production of GDP. It was down 1.3 percent in 2022 compared with 2021. Among the 12 largest economic sectors, which represent 90% of gross value added, seven showed positive growth rates. Among them was "Public administration, defense, social security" with 4.1% growth, benefiting from increased spending on military and security services, and mining with 0.4%, as its companies were stimulated by high commodity prices to fully utilize their extraction capacities. Among the sectors with declining gross value added, trade stood out with a 12.7% drop, mainly due to the fact that motor vehicle trade fell by 45%. In the largest sector of the economy, manufacturing, output declined by 2.4% in 2022 compared with 2021.

Within the economic sectors, the individual industries showed different rates of change: Manufacturing industries with increasing output included the production of "fabricated metal products except machinery and equipment" (up 7.0%), "computers, electrical and electronic products" (up 1.7%), and "other machinery and equipment" (up 1.3%), which includes the production of munitions and weapons systems. However, militarily important goods are also produced in a large number of other sectors.

Use of GDP

The GDP expenditure account suggests that the consequences of war and sanctions have had at least some impact on Russia's economy: Only the government sector (at 2.8%) and fixed investment (at 5.2%) showed real (inflation-adjusted) growth in 2022 compared with 2021. In both cases, arms orders probably played a role: Government consumption includes not only the maintenance of the government apparatus but also personnel expenses and current expenditure on property, plant and equipment for military purposes. Fixed capital formation includes not only investment costs incurred by companies for the production of civilian goods - by international convention - but also the acquisition costs of weapons systems (with a planned useful life of more than one year, i.e. tanks, military vehicles, guns, aircraft, ships, etc.).

In the GDP expenditure account published by Rosstat 2023 until April, the data for imports and exports as well as their rates of change are missing for 2022. Supplementary information on foreign trade can be obtained from the Central Bank statistics, of which only an abridged version has been published up to April 2023: While Russia's export earnings in 2022 exceeded those of 2021 by 14% ($78 billion), the value of imports was 9% ($34 billion) lower. This resulted in a 66% ($112 billion) year-on-year increase in the balance of trade and services (the external contribution to GDP). The combination of lower imports and increased exports, and the associated inflow of foreign currency, primarily prevented Russia's economy from experiencing a pronounced economic crisis in 2022.

State budget and defense spending

The federal budget is published by the Ministry of Finance. As expenditures were about 12% higher than revenues in 2022, the budget deficit accounted for 2.2% of GDP, compared with a surplus of 0.4% in 2021. While in 2021 both domestic and external federal debt were reduced, in 2022 a reduction in external debt was offset by a significant increase in internal debt.

In 2022, federal budget expenditures exceeded government consumption as reported in the expenditure account of GDP by 15%, while this ratio had been six percent in 2021. This is likely due to the fact that government spending, unlike government consumption, includes investment, which includes the year-on-year increase in the commissioning of weapons systems and military buildings.

Since the beginning of 2022, the budget fulfillment statistics published by the Ministry of Finance no longer include a breakdown by individual expenditure items. However, the budget plan published by the Ministry of Finance in October 2022 does contain such a breakdown. For 2022, the consolidated (general government) budget included 4680 billion rubles for defense (a share of 3.2% of GDP) and 2971 billion rubles for security and justice (2.0% of GDP). For 2023, defense spending was planned to increase to 4983 billion rubles (3.3% of GDP) and security and justice to as much as 4609 billion rubles (3.1% of GDP). Since military-related expenditures may also be included in other budget items, this alone does not indicate the full extent of defense spending. Also, these data can only be compared with the defense expenditures of other countries if specific purchasing power parities are used instead of exchange rates.

Social Situation

Russia's statistics agency calculates "real disposable income" as the total sum of wages and salaries, entrepreneurial profits and monetary social benefits after deduction of taxes and contributions, taking inflation into account. This sum was only 1% lower in 2022 than in 2021, despite the 2% decline in GDP, for which war-related special payments to employees in the state apparatus and military may have been responsible. Also for 2022, official statistics show a decline in consumer spending by the population of about 2%, which may have been due to a lack of consumer goods due to a lack of imported goods and the withdrawal of Western retail chains from Russia. This is also indicated by the fact that the gross value added of the retail sector decreased by 6.8%.

Unemployment fell from 4.4% to 3.7% in 2022 compared with 2021, despite the decline in output on average for the year, which was probably related to partial mobilization as well as the flight of hundreds of thousands of workers abroad.

Sanctions against Russia's arms industry

Those sanctions that prohibit exports to Russia target primarily military-related goods, including those with both civilian and military uses (dual-use goods). These measures have been quite effective: Imports from countries such as Iran and China, which did not participate in sanctions against Russia, have not been able to fully replace the lost shipments, at least so far.

Production of certain military vehicles, such as the truck for the Pancir air defense system, as well as heavy military trailers, supply vehicles and special vehicles at the Kamaz plant was halted because the Bosch fuel injectors manufactured in Germany were no longer available. T-72 main battle tanks lacked French-made thermal imaging cameras and Japanese-made optical products; the production of several modern air defense weapons lacked German-made electronics. Cruise missile production was hampered by the unavailability of Taiwanese, Dutch, U.S. and Swiss components. Russia's state-of-the-art satellite-guided Tornado missiles lacked U.S.-made gyroscopes. Of course, it has to be expected that these components can be replaced by own production, albeit possibly with lower quality, and/or imported via third countries by circumventing the sanctions. Even the supply of military or dual-use goods that are actually prohibited continues to take place.

Although the extent of the economic sanctions imposed on Russia in 2022 was historically unprecedented, political success has so far failed to materialize. That they could persuade Russia to end its war of aggression on Ukraine, however, was not to be expected in any case, as a statistical evaluation of sanctions imposed since 1950 and their sanction effects shows.

Outlook

In its February outlook, the European Bank for Reconstruction and Development (EBRD) forecasts a further 3% decline in Russia's GDP in 2023 and does not expect weak economic growth of 1% until 2024. Expert estimates published by the Central Bank of Russia in February 2023 range from minus 6.5 to plus 0.4% for 2023, with a median estimate of minus 2.5%, while the median estimate for 2023 is plus 1.2. At the end of January 2023, the International Monetary Fund (IMF) projected economic growth of 0.3% in 2023 and 2.1% in 2024.

The editors of the business magazine Expert Tat'jana Gurova and Petr Skorobogatyj believe it is possible that Russia's economic output will grow by 7-10% annually in the coming years. In their opinion, the biggest growth driver will be the replacement of imports by domestic production at 3.5%, followed at 1.5-2% by an increase in the output of the military industry, at 1-1.5% by an improvement in living conditions, among other things through a housing construction program, and at 0.5-1% each, infrastructure investment for a "road to the east" toward China, as well as production growth in the four Ukrainian territories partially occupied and claimed by Russia in addition to Crimea: Luhansk, Donetsk, Zaporizhia, and Kherson. The authors assume that the state will generously subsidize this reorientation of the economy. They ignore the possibility that commodity prices could fall sharply, which would have a corresponding impact on the revenues of commodity-exporting companies and on state revenues. In this case, it is hard to imagine that Russia will experience economic growth in 2023.

About the author

Roland Götz, born in 1943, studied economics at the Free University of Berlin, received his doctorate for a thesis on mathematical models of Soviet price planning, and taught at the universities of Augsburg, Bielefeld, and at the Free University of Berlin. He worked on the Soviet economy and the economic transformation of the successor states of the USSR at the Federal Institute for East European and International Studies in Cologne and was responsible for the economy of the CIS states at the German Institute for International and Security Affairs in Berlin.

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