The Russian Economy and Sanctions Brief – October 2024

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September and early October of 2024 were tough for the Russian economy, with several negative trends accelerating:

- Inflation has remained high, proving that the Central Bank's recent rate hikes are not working; the key interest rate is expected to be raised again at the Central Bank's Board meeting on October 25 from current 19% to 20% or even 22%;
- Broader data indicates economic cooling;
- The Russian economy continues to experience supply shocks caused by Western sanctions; industrial output growth is at the lowest level since Spring 2022, and the labor shortage is breaking earlier records;
- The federal budget deficit is exploding; new government data suggests that it will be more than double the initial 2024 federal budget projections;
- The government faces more difficulties borrowing money; state bond yields are reaching historic highs (near 17%), and Russian Government Bond Index is hitting historic lows;
- Imports from China, a key trading partner since the economic decoupling between Russia and the West in 2022, continue to stagnate due to payments freeze caused by the Western sanctions.

The Central Bank is unable to cope with inflation

The Central Bank's efforts to tame inflation through tightening monetary policies have so far failed spectacularly. Inflation didn't calm down despite the July interest rate hike from 18% to 19%. In late September and early October 2024, weekly inflation remained as high as 0,14-0,19%, with annualized inflation staying within 8,5-8,6%.[1] According to the summary of the key rate discussion from the Central Bank's Board meeting on September 13, 2024,[2] "inflationary pressures remained high and the disinflation process observed in early 2024 had not resumed as yet," and "inflation in the third quarter of 2024 was higher than expected by the Bank of Russia."

It is assumed[3] that the Central Bank may raise the interest rate soon to

1 https://www.interfax.ru/business/986034
2 https://cbr.ru/eng/dkp/mp_dec/decision_key_rate/summary_key_rate_25092024/
3 https://www.finam.ru/publications/item/bank-rossii-mozhet-povysit-klyuchevuyu-stavku-

as high as 22% (its next board meeting being scheduled for October 25) and opt for further hikes in early 2025 if inflation doesn't abate. In any case, the Central Bank promises to maintain high interest rates throughout 2025 and 2026, hampering economic growth.

The Central Bank has also voiced concerns[4] about the inflation spiral getting out of control, driven by demand overheating and elevated inflation expectations. According to the earlier cited summary of the key rate discussion, "inflation expectations were rising despite the tightening of monetary policy, which could suggest that they were becoming less anchored, that is, more adaptive … As a result, households' and businesses' demand might continue to grow rapidly, which would hinder the disinflationary trend and require maintaining a tighter monetary policy for a longer period."

The inflation expectations received an additional boost with the publication of a draft budget for 2025-2027 by the Russian government, which had revised the projected federal budget deficit for 2024 from RUR 1,6 trillion (as forecasted in December 2023) to RUR 3,3 trillion.[5] The Central Bank has admitted that such a sharp increase hadn't been expected[6] by the financial regulator and might force it to tighten the monetary policies further.[7]

The openly admitted fact that the Russian Central Bank had no idea about the budget deficit level for this year less than three months before the year's end speaks volumes about the disarray within the Russian corridors of power, contrary to the assertions of many Western commentators impressed by Putin's ability to control the Russian economy.

High inflation rates are a direct product of Putin's war against Ukraine and the effectiveness of the Western economic sanctions. The Russian Central Bank admits[8] that a key pro-inflationary factor is the inability of supply to catch up to demand fueled by war-related budget stimulus. The supply crisis, in turn, is a result of a resource shortage underpinned by:

1. A near-full utilization of manufacturing capacities that cannot be expanded quickly due to a lack of access to investments and technology;

2. A strong and growing deficit of labor force caused by the war, mobilization,

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4 https://www.kommersant.ru/doc/7213873

5 https://www.interfax.ru/business/984433

6 https://www.interfax.ru/business/984539

7 https://www.kommersant.ru/doc/7198605

8 See "Summary of the Key Rate Discussion" at Central Bank's Board on September 13, 2024, https://cbr.ru/eng/dkp/mp_dec/decision_key_rate/summary_key_rate_25092024/: "High domestic demand outstrips the economy's productive capacity and remains the key factor in persistently elevated inflationary pressures"

and mass emigration brought about by Putin's aggression against Ukraine.

Given that these two major resource constraints are not likely to be mitigated any time soon, it is improbable that the Central Bank's efforts to bring down inflation through the monetary policies would bear fruit in the near future. Key market players expect high interest rates (and, possibly, more rate hikes) in the coming months and well into 2025.

According to Central Bank, the labor shortage remains at an all-time high.[9] This trend has been recently exacerbated by the populist measures targeting foreign migrant workers. According to surveys by HeadHunter and the Russian Union of Industrialists and Entrepreneurs, demand for foreign labor is growing, but more than half of the companies that employ such workers cannot hire them in sufficient numbers.[10]

Economy is cooling

Against a backdrop of persistently high inflation, the Russian economy shows clear signs of rapid cooling. This does not come as a surprise, since Russia's recent economic growth, is in essence the result of the bounce-back effect from the first hit by the Western sanctions and massive budget stimulus. Now, a lack of investment and productivity-boosting reforms are rendering Russia unable to sustain the 3-4% annual GDP growth trend.

Various data across the sectors of the economy provides conclusive evidence. In August 2024, according to the Russian Ministry of Economic Development, GDP growth slowed to mere 2,4%[11] in annual terms as opposed to 5,4% in the first quarter of 2024. Industrial growth in August was below 3%, at the lowest level since March 2023.[12] **The Central Bank's baseline scenario for GDP growth in 2025 is between 0,5% and 1,5%,[13] falling short of the current growth rates.**

According to S&P Global, the Russian manufacturing PMI slipped into negative territory in September 2024 for the first time since April 2022,[14] while the services PMI fell to 50,5, down from 52,3 in August. The S&P Global Russia Composite PMI Output Index posted at 49,4, down from 52,1 in August, signaling "a renewed contraction in private sector business activity."[15]

The Central Bank's "Summary of the Key Rate Discussion" from

9 https://www.interfax.ru/business/981882
10 https://www.kommersant.ru/doc/7213864
11 https://www.interfax.ru/business/984942
12 https://www.interfax.ru/business/983677
13 https://cbr.ru/eng/press/event/?id=20972
14 https://www.pmi.spglobal.com/Public/Home/PressRelease/9824219f5c2940beb4d91b9abc0a2f7b
15 https://www.pmi.spglobal.com/Public/Home/PressRelease/4555a978a0014efaaff67fab07589992

September 13, 2024,[16] confirms that "economic growth slowed down from the first to the second quarter of 2024. According to high-frequency data and surveys, economic growth continued to decelerate in July-August. The economy showed signs of a slowdown in consumer and investment activity. In September, the Bank of Russia's Business Climate Index was down in terms of current demand and output estimates."

The Ministry of Economic Development anticipates a sharp output contraction in the manufacturing industries, from 7% growth in 2024 to 2,9% in 2025.[17] That includes a decline in growth rates in the military manufacturing sector, affecting "finished metal products" (weapons and ammunition), "other transport vehicles" (battlefield vehicles, battle tanks, aircraft), and "electronics and optics."

In addition, the Central Bank is growing concerned about the Russian economy entering a stagflation scenario,[18] for "there are indeed signs of cooling in domestic demand; however, inflationary pressures are not easing," as per the "Summary of the Key Rate Discussion." The stagflation risk was overtly mentioned by Central Bank Governor Elvira Nabiullina during an interest rate press conference on July 26.

The draft federal budget for 2025: a budget of scarcity

The Russian government has published the draft federal budget for 2025-2027, submitting it to the State Duma. Here are several major takeaways.[19]

Firstly, much media commentary on the matter was devoted to another increase in military spending that is set to grow to a new record-breaking level of RUR 13,5 trillion per year.

Less notable, but probably a more important factor is a slowdown in the growth of military expenses. From 2023 to 2024, they increased by 68%; and by 35-40% year-on-year during the first two years of Russia's full-scale invasion of Ukraine, 2022-2023. The planned increase in military expenditure is just 26% for 2025, the lowest since the beginning of the full-scale invasion of Ukraine.[20] Adjusted to inflation, it translates to slightly over 15% in real

16 https://cbr.ru/eng/dkp/mp_dec/decision_key_rate/summary_key_rate_25092024/

17 https://www.rbc.ru/economics/16/09/2024/66e406be9a7947a2875d0c3b

18 https://www.agents.media/tsb-uvidel-pervye-priznaki-stagflyatsii-v-rossii/

19 Data provided below is taken from the "Explanatory note to the draft federal law "On the federal budget for 2025 and for the planning period of 2026 and 2027" as published at the Russian State Duma website (https://sozd.duma.gov.ru/bill/727320-8). Relevant page numbers are indicated in each case specifically

20 "Explanatory note to the draft federal law "On the federal budget for 2025 and for the planning period of 2026 and 2027" (https://sozd.duma.gov.ru/bill/727320-8), page 233

terms, which is underwhelming in light of pressing spending needs related to the production of weapons and ammunition, supplies for the army, and salaries for servicemen.

Such a modest indexation of the military expenditure is yet another testimony to the scarcity of funds the Russian government is facing. It is projected that the growth in overall federal expenditures in 2025 will be 5,2% year-over-year, dramatically down from 22% year-over-year in 2024; and that the government will maintain the federal budget deficit within RUR 1,2 trillion, or 0,5% of GDP.[21] This looks like a rather severe belt-tightening.

However, the Russian government's record of fulfilling its commitments to keep the spending and deficit under control since the beginning of the full-scale invasion of Ukraine in 2022 has been exceptionally poor. When adopting a federal budget for 2022-2023, the government always promised to maintain relatively mild budget deficits, but in reality, the deficit invariably exceeds the planned numbers, exceeding RUR 3 trillion per year.[22] The same situation took place in 2024, as discussed earlier: the actual budget deficit for 2024 is expected to reach RUR 3,3 trillion, doubling the initially projected figure (RUR 1,6 trillion)[23].

Given the lack of access to international financial markets and investment, which amplifies the urge for the federal government to spend more cash to sustain the economy and to continue the war; and economic cooling, which will inevitably reduce the tax revenue base, it is highly unlikely that the Russian government will do a better job limiting the spending than it did in 2022-2024.

The projected federal budget deficit for 2024 —RUR 3,3 trillion— amounts to 64% of the remaining liquidity reserves in the Russian National Wealth Fund, or NWF (RUR 5,3 trillion).[24] **If, as in the previous years, a significant part of the remaining NWF funds is spent to finance the budget deficit[25], Russia meet 2025 with depleting reserves. In September 2024, the Central Bank admitted that the exhaustion of the liquidity portion of the NWF in 2025 was a possible scenario**.[26]

The budget scarcity compels the Russian government to reduce spending on "social policy"— mainly transfers to Pension Fund—by RUR 1,2 trillion, or

21 "Explanatory note to the draft federal law "On the federal budget for 2025 and for the planning period of 2026 and 2027" (https://sozd.duma.gov.ru/bill/727320-8), page 21
22 "Explanatory note to the draft federal law "On the federal budget for 2025 and for the planning period of 2026 and 2027" (https://sozd.duma.gov.ru/bill/727320-8), page 21
23 https://www.interfax.ru/business/984433
24 https://www.kommersant.ru/doc/7212922
25 https://www.interfax.ru/business/940594
26 https://lenta.ru/news/2024/08/29/empty/

16%.[27]

Another substantial spending hike to feature in the coming years thanks to the growth in military spending will have to do with servicing the federal debt. The deteriorating economic situation along with high inflation and interest rates have made the costs of borrowing for the Russian government skyrocket, resulting in a sizeable surge in debt servicing expenditures. They are expected to increase from RUR 1,5 trillion (less than 5% of the total federal budget spending) in 2023 to over RUR 3 trillion (almost 8%) in 2025. The draft federal budget shows a 275% increase in the costs of servicing the federal debt from pre-war levels, second only to the 400% military spending growth .

An ongoing federal debt crisis

Higher inflation and interest rates, as well as the overall economic uncertainty, continue to boost yields for Russia's government bonds, seriously impairing the country's ability to solve its budget problems through domestic borrowing (the Western sanctions have cut the Russia off from international financial markets). In early October 2024, Russian government 10-year bond yields (OFZ) hit a staggering level of 16,7%[28] compared to 11-12% in the beginning of 2024. In response, the Ministry of Economic Development suspended auctions offering fixed-rate OFZ bonds in an attempt to prevent, at least temporarily, any further rise.

Russian Government Bond Index (RGBI), which reflects investors' trust in the government's ability to service its debt, is near all-time lows, having fallen below 100 in early October 2024, for the first time since March 2022. There were only a couple of short periods in February 2009 and March 2022 when the RGBI index was below 100; it traded above that level nearly all the time since its introduction in late 2002.

While the federal debt as such is relatively low at 17% of GDP, debt servicing costs are booming. This impairs the government's ability to borrow money to fill the spending gap: during the third quarter of 2024, the Ministry of Economic Development realized the target domestic borrowing only by 45%,[29] putting the implementation of the annual borrowing plan for 2024 at serious risk.

27 https://www.agents.media/vlasti-urezhut-rashody-na-sotspolitiku-na-1-2-trln-rublej/
28 https://tass.ru/ekonomika/22024117
29 https://www.interfax.ru/business/983644

Payments freeze

Following the start of the full-scale invasion of Ukraine, as trade with the West collapsed, China has become Russia's main trade partner. Since Russia depends on China for the lion's share of technologies and components for its manufacturing industries, imports from the PRC are vital to keep the Russian economic engine running.

This year, however, Sino-Russian trade has been severely impeded by the export/import payments freeze following a sweeping refusal of Chinese banks and companies to work with Russian counterparts due to the threat of secondary Western sanctions. According to the data from Chinese Customs,[30] Russian imports from China grew only by 0,4% year-over-year after 8 months of 2024, while in 2023, the growth rate for Chinese imports was nearly 50%. Such a pronounced drop will inevitably contribute to further economic weakening.

Economic relations between Russia and China haven't been showing any progress throughout 2024. No important energy deals have been signed. This includes the Power of Siberia 2 gas pipeline touted by the Kremlin, but in which the official Beijing has never publicly confirmed an interest. It has been reported[31] that the Chinese government strongly advises car manufacturers not to invest in new plants in Russia. Russian coal[32] and steel[33] exporters confront severe challenges from Chinese import tariffs and a contraction of demand caused by Chinese economic slowdown.

Impacts on Putin's ability to wage war in Ukraine

Putin's ability to continue the aggression against Ukraine in the long run is seriously compromised:

- For over two years, the record-breaking labor shortage has delayed a follow-on wave of mandatory mobilization;
- The budget scarcity allows only for a 15-16% military spending increase in real, inflation-adjusted terms, which is clearly insufficient to solve the urgent problems with military production, the army supply system, and the servicemen salaries, as explained in more detail in our August brief;

30 https://www.kommersant.ru/doc/7048349
31 https://www.reuters.com/business/autos-transportation/china-warns-carmakers-risks-building-plants-overseas-sources-say-2024-09-12/
32 https://www.vedomosti.ru/business/articles/2024/08/26/1057904-rossiiskie-eksporteri-uglya-sokraschayut-postavki-v-kitai
33 https://pro.rbc.ru/demo/66bf8f739a794749feb18e4b

- The high inflation rates necessitate a further increase in military spending that the government cannot currently afford;
- Russia's military-industrial output growth is rapidly slowing down due to the lack of funding and access to technology combined with a crippled ability to build new production lines.

Conclusions

While Russia still has some resources to continue the war against Ukraine, its economic situation is manifestly deteriorating. The economy is cooling, the inflation is out of control, and the Central Bank's efforts to calm it through the tight monetary policies have failed to yield any results. High interest rates are expected to be maintained for a protracted period of time, hampering economic growth.

Economic recovery is obstructed by a comprehensive export-import payments freeze in relations with China and other countries of the Global South caused by the fear of Western secondary sanctions. The reduction of imports of critical technology and manufacturing components, in turn, slows output growth. Supply constraints driven by the lack of free production capacities and the record-breaking labor shortage are slowing the economy down and driving inflation up. The stagflation scenario is looming, as acknowledged even by the country's Central Bank.

The growth in military spending, according to the draft federal budget for 2025, is supposed to be the least significant since the beginning of the full-scale invasion of Ukraine: mere 26%, or 15-16% in real terms adjusted to inflation. It reflects a shortage of the financial reserves, as well as the difficulties with raising debt financing due to skyrocketing yields for government bonds.

If the Western sanctions pressure is maintained and increased in the coming months, 2025 will make it very difficult for Vladimir Putin to continue his war in Ukraine at its current level of intensity.

The next important event to watch: the October 25, 2024 Central Bank's Board meeting on interest rate.