FRF THINK TANK

report

# RUSSIAN ECONOMY AND SANCTIONS BRIEF

November 2024

**Vladimir Milov**

Free Russia Foundation
2024

# Executive Summary

October and early November of 2024 showed key negative trends for the Russian economy intensifying, making the much-discussed stagflation scenario more real:

> **Inflation continued to rise,** defying the Central Bank's tight monetary policies and key interest rate hikes;
>
> **At the same time,** data indicates a continued cooling of the Russian economy as a result of high interest rates;
>
> **This has increased the high-level pressure** from industrial lobbyists on the Central Bank to lower interest rates, which is highly likely lead to a showdown in the coming months, negatively impacting macroeconomic stability in case Putin's government gives in to lobbyist demands and softens monetary policies;
>
> **If the Central Bank** is able to sustain tight monetary policies, however, Russian economic growth may vanish;
>
> **A stagflation scenario for the Russian economy,** which seemed far-fetched just a while ago, is now openly and broadly discussed within government circles.

There are several potential silver linings for the Russian economy, which may mitigate some of the negative trends and provide partial relief for Putin, though not necessarily turning the situation around completely:

> **The election of Donald Trump**, which sparked rallies at the Russian stock and government bond markets;
>
> **A significant improvement** of the situation with export-import payments with China and resumption of high growth of imports of Chinese goods due to the effective adaptation of Russia and China to mutual payments challenges caused by the risks of Western secondary sanctions.

# Debate on the Central Bank interest rates is heating up

Despite another rise in interest (this time to 21%) on October 25, inflation continues to grow. The weekly inflation rate between November 5 and 11 was 0.3%[1], the second-highest weekly inflation in 2024, right behind the week of July 1, 2024 (which saw the planned utility tariffs hike). The monthly inflation rate in October was 0.75% relative to previous month, up from 0.2% in August and 0.48 in September[2]. During the first 11 days of November, inflation was 0.42% relative to previous month. The annualized inflation on the last recorded date (November 11) was 8.56%.

As it is evident, inflation is not at all sensitive to the Central Bank rate hikes. The key interest rate has been raised for over 15 months now (since end-July 2023).  Just in the past three and a half months, it was raised by 5 percentage points, from 16% in late July to 21% in early November. However, the growth of prices remains unaffected.

In November, the Central Bank released the transcript of the discussion on key interest rate that took place at the Bank's October 25 Board meeting[3]. Highlights include:

> The increased in inflationary pressure, with most indicators of sustainable inflation approaching their 2024 maximums; inflation superseding the Central Bank's earlier forecasts;
>
> High demand, not supported by adequate increase in output as the main inflation driver; the output lag is a direct result of Western sanctions, among other factors, as discussed in our October brief[4];
>
> Unexpected increase of federal budget spending by RUR 1,5 trillion announced in the Fourth Quarter of 2024 is a significant new pro-inflationary factor;



[1] Rosstat, 'On the assessment of consumer price index from November 6 to 11, 2024'
[2] Rosstat, 'On the consumer price index in October 2024'
[3] Central Bank of Russia, 'Summary of the discussion of the key rate during the "week of silence"'
[4] Free Russia Foundation, 'The Russian Economy and Sanctions Brief - October 2024'

Economic growth is slowing down in meaningful ways;

The labor shortage is at an all-time high and is a major factor constraining output;

Most members of the Central Bank's Board agreed that non-increase of key rate in December would only be possible if a significant slowdown in sustainable inflation occurs, but ‘there are few prerequisites for this so far; the risks are shifted toward the pro-inflationary ones’;

The key rate forecast has been increased for 2025-2026: in 2025, it is expected to fall between 17-20%, in 2026 —12-13%, with no single-digit rate prospect for at least the next two years.

Photo: cbr.ru

During the past month, the war-related shortage of labor in Russia reached another historic record[5], and the Central Bank now says that it sees ‘no silver lining’ on the Russian labor market[6].

The Central Bank is steadfast in its efforts to crush inflation with interest rate hikes, promising to increase key rate again at its next Board meeting on December 20 ‘if there is no significant slowdown in inflation by then’. Given the fact that in late October and early November the inflation notably accelerated instead of slowing down, the likelihood of a scenario where the Central Bank refrains from hiking key rate in December is vanishing by the day.



[5] Moscow Times, ‘Central Bank has recorded a new record for labor shortages’
[6] Interfax, ‘Bank of Russia does not yet see “any silver linings” in the labor market’

At the same time, industry lobbyists have intensified the pressure on the Central Bank to stop interest rate hikes and reverse its policies. In late October, the powerful CEO of Rostec Sergey Chemezov (Russia's main producer of arms supplying up to 80% of weapons for the battlefield in Ukraine), speaking at the plenary of the Federation Council, openly called for a swift end to the Central Bank's tight monetary policies, threatening bankruptcy of 'most' of the military enterprises, and a significant contraction of arms exports[7]. The Central Bank's leadership continues to be slammed at various fora by industry reps who predict mass closures of enterprises and need to cut investment programs — as it was the case at the recent Russian Economic Forum in Chelyabinsk[8]. The Russian Union of Industrialists and Entrepreneurs forcefully called for legislative changes aimed at reducing the Central Bank's independence and introducing the Cabinet of Ministers into the process on making decisions on monetary policies[9].

The lobbyists' onslaught was followed by the heavy macroeconomic artillery: in mid-November, the Russian Center for Macroeconomic Analysis and Short-Term Forecasting (known under the Russian abbreviation CMAKP) published a report 'On the risks of stagflation in the Russian economy'[10], arguing that 'the current high level of the key rate and the prospects for its further increase by the Central Bank have created the risk of an economic downturn and a collapse in investments in the near future'. CMAKP is arguably Russia's most influential macroeconomic analysis center: it was founded in the 1990s by the current Minister of Defense Andrey Belousov, who had served as Putin's chief economist for years before moving to the Government, and is currently chaired by Belousov's brother, Dmitry. CMAKP's unofficial moniker is 'the Belousov's Center', and its services are broadly used by the Russian Government in macroeconomic forecasting.



[7] TASS, 'Rostec may stop exporting high-tech products'
[8] Vedomosti, 'Industrialists warn the Central Bank about production stagnation due to the key rate'
[9] Vedomosti, 'Business asks for more powers for government in monetary policy'
[10] CMAKP, 'On the risks of stagflation in the Russian economy'

CMAKP report on stagflation cements what had been evident for a while: the talk of stagflation scenario has become the new normal in the Russian public discourse on the economy. Even major monetary policy decision-makers such as Sergey Chemezov and Elvira Nabiullina have admitted the real possibility of stagflation scenario in their recent public speeches. Therefore, the CMAKP stagflation report has moved the debate on stagflation scenario from public rhetoric into macroeconomic forecasting. Ironically, this happens concurrently with Western media outlets publishing articles that the Russian economy is ‘doing well’ under sanctions.

There are elements of truth on both sides:

> The Central Bank's high interest rates impede growth, curb investment and lead to stagflation or recession;
>
> Easing the Central Bank's monetary policies would likely lead to a much higher inflation.

**Sergey Chemezov**
CEO of Rostec Corporation

Photo: Press Service of the Federation Council

The ‘elephant in the room’ here is Russia's war against Ukraine, which has led to Russia's isolation, cutoff from investment and technology, and extreme military spending hikes, which are the key cause of the current inflation. But no criticism of Putin's war is allowed in the Russian corridors of power, which is why this factor is not even mentioned in the debate.

However, without ending the war and Russia's international isolation, and without drastically reducing the current military spending, Russian inflation will not go away, regardless of what happens to the Central Bank's monetary policies. In the longer run, the Central Bank doesn't seem likely to withstand the pressure from lobbyists, and the tight monetary policies will be relaxed at some point in the future.
It is inconceivable that Putin would allow a mass annihilation of industrial enterprises by prohibitive interest rates.

On the other hand, even if the Central Bank's succeeds in bringing down inflation through rate hikes— which is not likely, because inflation is caused by problems other than monetary policy (heavy military spending, output gap)— there will be no mass influx of investment fueling economic growth. The Central Bank de-facto recognizes this, offering a sluggish economic growth forecast. For 2025, the Bank's baseline scenario forecast is just 0.5-1.5% GDP growth[11]. But should the lobbyists win, and the Central Bank is forced to soften its rate policy, the inflation may get out of control, just as the Central Bank Governor Elvira Nabiullina warns.


**Elvira Nabiullina**
Governor of the Bank of Russia

Photo: cbr.ru

In other words, there are no good economic scenarios for Putin.
The choice is between a stagflation (or recession) caused by the Central Bank's tough policies, and a much higher spike in inflation if the Bank's rate policy is relaxed. **The only solution to this dead-end situation is to end the war and Russia's international isolation.** However, this option is not on the table for Putin yet, leaving him with the choice between stagflation and hyperinflation.



[11] See footnote 3

# Economic slowdown

Russia's GDP growth in the third quarter of 2024 slowed down to 3.1% year-on-year as per Rosstat[12], as opposed to 4.1% reported for the second quarter and 5.4% in the first quarter of 2024. The slowdown continued well into the fourth quarter of 2024. The slowdown of economic activity in October 2024 was reported by both the Central Bank[13] and the Ministry of Economic Development[14]. For 2025, the Central Bank's baseline scenario forecast is 0.5-1.5% GDP growth (see above). The number will likely be revised downward at the Bank's Board meeting on December 20.

Given the current trends, it will be difficult to turn the economic slowdown around, as high interest rates serve as key impediments to investment— which is now officially recognized in macroeconomic analysis including the above mentioned CMAKP stagflation report.



[12] Rosstat, 'On preliminary assessment of GDP dynamics in the third quarter of 2024'
[13] Kommersant, 'Central Bank: Russian economic growth is gradually slowing down'
[14] Interfax, 'Reshetnikov said that the Russian economy is showing signs of cooling'

# Budget situation

In early October, Russian government announced massive increase of federal budget deficit for 2024 from the initially projected figure (RUR 1.6 trillion) to RUR 3.3 trillion, exceeding the planned figure for 2024 more than twofold[15]. Apart from the growth in military spending, the Central Bank interest rate hikes have greatly contributed to the unexpected growth in federal expenditure: Russian Minister of Finance Anton Siluanov points to mortgage and other loan subsidies, alongside spending on the war, as key factors driving the federal spending and the deficit upward[16]. As indicated by the Central Bank[17], unexpected growth in federal budget spending is currently a major pro-inflationary factor.

**Anton Siluanov**
Minister of Finance of the Russian Federation

Photo: TASS

Most additional expenses are planned to be allocated in December 2024, to be financed through the drawdown of financial reserves from the National Wealth Fund (NWF), that is expected to be significantly depleted by January 1, 2025. The exact figure of remaining NWF funds after financing the massive budget deficit of 2024 will become clear some time by mid-January 2025.



15 Interfax, 'The Russian budget deficit estimate'
16 RBC, 'Siluanov revealed what the additional ₽1.5 trillion will be spent on in 2024'
17 See footnote 3

The government doesn't have other sources to fill the budget gap apart from the drawdown of NWF funds. Urals crude oil has been trading just slightly above $60 per barrel in September-October (Russian federal budget for both 2024 and 2025 was drafted under the assumption of average Russian oil export price of $70 per barrel).

Borrowing is also not an option either due to high interest rates. Between January-October 2024, the Russian government spent nearly the same amount of money on servicing the debt as it borrowed from the market through OFZ bonds.  If the repayment of principal debt is accounted for, net receipts to the federal budget from borrowing were minus RUR 1.3 trillion (the government spent RUR 1.3 trillion more on repaying and servicing the debt than they have raised through OFZ bond placements)[18]. In the current environment, borrowing doesn't provide the funds needed to cover budget deficit. The government spends more on servicing the debt under the current interest rates.



[18] Ministry of Finance of Russia ‘Key indicators of federal budget execution in 2024’

# The looming real estate crisis

One of the major developments of the recent months—particularly since the Russian government had ended the state-sponsored subsidized mortgage program from July 1, 2024—are the financial difficulties faced by Russian developers, which may lead to a full-blown real estate crisis. Driven by subsidized mortgage rates, highly burdensome for the federal budget, the demand for housing had grown enormously, but the closure of state-sponsored subsidized mortgage program in July 2024 has led to falling prices and demand for housing[19]. Russian developers, who bet big on the continuation of state-sponsored subsidized mortgage program, are now heavily leveraged with debt and unsold housing that is not in demand anymore: by mid-2024, nearly 80 mn square meters of new housing remained unsold in new buildings in Russia, or 67% of all new housing[20].

This has led to devastating consequences for Russian developers: for instance, the Samolet Group, Russia's largest developer, faced operating losses in the third quarter of 2024, and is at a serious risk due to growing interest rates, being heavily indebted. Samolet's shares lost two-thirds of their value since early 2024 amid publication of the third quarter financial results and exit of its main shareholders, which indicated bad prospects for the company[21]. Russia's second-largest developer, the PIK Group, also lost about half of the value of its shares since the first half of 2024. The company is supposed to publish the third quarter financial results before the end of November, which will allow to make better judgment on whether the crisis among Russia's developers is systemic.

This would have a major impact on Russian banks, because developers were among the most active borrowers. Russian Deputy PM Marat Khusnullin has recently admitted that bankruptcy of some developers is ‘possible’[22].



[19] RBC, ‘The decline in housing prices in Russia accelerated again in October’
[20] RBC, ‘The share of unsold new buildings has increased in Russia’
[21] Forbes Russia, ‘The largest co-owner of the developer GC Samolet sells his stake’
[22] Lenta.Ru, ‘Possibility of developers' bankruptcy admitted in Russia’

# Payment crisis with China partially resolved

Earlier in 2024, Russia experienced serious problems with export-import payments in trading with China, due to a heightened caution against Russian counterparts exercised by Chinese banks and companies facing risks of the U.S. secondary sanctions. However, this problem seems to have been gradually resolved. A key indicator here are the dynamics of imports of goods from China: when the payment crisis hit the worst in March-April 2024, it was down 13-14% year-on-year. However, after the wobbly performance during spring and summer, imports of goods from China resumed significant growth: 17.3% year-on-year in September 2024, and as high as 26.5% in October[23]. This is still short of 47% annual growth of imports from China in 2023, but nevertheless indicates that the worst of Russia-China payment crisis is over, and both countries have found innovative measures helping to avoid risks of exposure to the U.S. secondary sanctions.

While the rebounding of Chinese imports contributes to a renewed depreciation of the ruble rate, which is bad news for inflation, it may also provide  a significant boost to the Russian output growth through import of vital Chinese industrial goods and technology, whose lack contributed to supply-demand gap and high inflation.

These links underscore **the importance of the West maintaining constant pressure through regularly imposing new sanctions against Chinese individuals and entities helping Russia find new ways of sanctions evasion.** Failures or conspicuous pauses in this work may lead to swift rebounding of the Sino-Russian trade, as we are observing today.



[23] Vedomosti, 'Russian-Chinese trade turnover increased by 2.8% in January-October 2024'

# Possible consequences of the Trump Presidency

Russian markets responded to the election of Donald Trump as 47th President of the United States with optimism, anticipating a relief from US sanctions against Russia. Russian stock market index (IMOEX), which had lost nearly 30% of its value since May, surged by nearly 10% (but later stalled). Russian government bond index (RGBI), which fell to historically low level just above 96 points at the end of October (in Summer 2022, it was trading near 140 points), rebounded to above 100 points. This has allowed the Russian Ministry of Finance to hold some of its most successful government bond placement auctions on November 13, managing to bring 10-year OFZ government bond yields down to below 17%[24], a level of early October (in late October, OFZ yields surged above 17%).

Longer-term consequences of Trump presidency for the Russian economy are hard to assess at this moment. The sustained monitoring of compliance with sanctions and sanctions evasion (like in the case of Russia's trade with China) would be critical to ensuring that Russia doesn't get away with new circumvention schemes. It is essential to continue focusing the efforts of all the relevant U.S. agencies (Office of Foreign Assets Control, Bureau of Industry and Security) on tracking Russian sanctions evasion schemes and making permanent or codifying relevant measures against new schemes and players involved in sanctions evasion.

Even a pause in this work, let alone reducing the the staff dedicated to these efforts, would allow Russia a broad space for circumventing the sanctions, seriously impairing sanctions effectiveness. In this regard, Russia may seriously benefit not even from lifting of any sanctions by Trump administration—on which there's no clarity yet— but simply from a notable decline in efficiency of operations of the part of U.S. Government which is responsible for sanctions policy.



[24] https://www.interfax.ru/business/992518

# Impacts on Putin's ability to wage war in Ukraine

**All the recent developments described above are seriously impairing Putin's ability to continue his war against Ukraine in the longer run:**

> The output - including military industries - is being seriously held back by sanctions and, most recently, prohibitive interest rates;
>
> The current standoff between the Central Bank and industrial lobbyists on monetary policies risks Russia entering either stagflation/recession or a hyperinflation scenario, both of which would impair Russian industries and military production;
>
> The record-breaking labor shortage reduces the possibility of another round of mandatory mobilization since the first one conducted over two years ago;
>
> Government budget is on the brink of running out of cash to finance the war, which will become even more apparent in early January 2025, after the data on the depletion of the National Wealth Fund in 2024 is published.

# Conclusion

Putin still has resources to continue the war against Ukraine, but, in October-November 2024, deterioration of the economic situation has accelerated. Stagflation scenario for the Russian economy is now regularly discussed as likely in the corridors of power. The Central Bank's tight monetary policies and interest rates have, so far, failed to bring down the inflation, and are unlikely to yield better results in the future — because inflation, is to a large extent fueled by factors beyond the Central Bank's control: heavy military spending, output gap resulting in extra budget funds fueling price growth rather than value creation.

The Central Bank's interest rate hikes contribute to a notable slowdown of the economy, which risks significant contraction of investment and business activity, including in the military sectors. This has already sparked a heated debate between major industrial figures like Rostec CEO Sergey Chemezov and the Central Bank leadership, which risks either major industrial contraction (if the Central Bank wins the debate and maintains high interest rates) or inflation spiraling out of control (if industrial lobbyists win and the Central Bank rate policy is relaxed) in 2025. Neither scenario is good for Putin and his ability to continue the war against Ukraine.

Maintaining the pressure of Western sanctions against Russia is absolutely critical in this situation. If the sanctions are relaxed even slightly, or if their enforcement stalls or deteriorates, Putin will get an unnecessary breathing room in an otherwise very difficult economic situation. If the sanctions are enforced, maintained and increased, Putin would face an increasingly challenging economic environment in 2025, which would dramatically reduce his ability to continue the full-scale war against Ukraine.

# Things to watch in the near future

Several things are most important to watch to understand the dynamics of the Russian economy:

> Meeting of the Central Bank's Board of Directors on December 20, which will likely issue a decision on key interest rate hike;
>
> The ongoing debate on monetary policy between the Central Bank and influential industrial lobbyists insisting on turning the current policies around and lowering the interest rate;
>
> The drawdown of cash from the National Wealth Fund (NWF) in December 2024 with purpose of financing the federal budget deficit, which would likely reduce the available cash to a historic minimum.

FRF
THINK TANK

thinktank.4freerussia.org