Russia*

Highlights

- **The economy has been hit hard by sanctions but has also shown resilience.** The impact of the sanctions imposed by many countries after Russia's invasion of Ukraine has been mitigated by the significant buffers built up since 2014 and by the high global prices of oil and gas.
- **Policy response has helped to keep inflation in check.** The sanctions initially caused the rouble to depreciate heavily but the authorities' response – notably capital controls and sharp rate hikes by the central bank – resulted in a strong recovery of the rouble to above pre-invasion levels.
- **Structural reforms have largely stalled.** The increased isolation of Russia is already having a negative impact on productivity and growth, and the authorities' focus on the ongoing war has meant that much-needed reforms have been delayed or halted.

Key priorities for 2023

- **The priority for Russia is to end hostilities and seek to re-establish itself as part of the global economy.** Such a step seems unlikely in the short term, as the country has become increasingly isolated since the annexation of Crimea in 2014, and all the more so since the invasion of Ukraine in February 2022.
- **Beyond the conflict, reducing the role of the state would help boost growth, entrepreneurship and the competitiveness of the private sector.** From a structural perspective, the Russian economy suffers from a lack of diversification, being heavily dependent on commodity exports, with a dominant public sector and a challenging business environment.
- **Efforts are needed to promote innovation, digitalisation and technology development.** Such a programme would improve the productivity of the private sector and foster the growth of the manufacturing and services sectors. However, the loss of vital technology imports as a result of sanctions has seriously impacted the manufacturing sector, and the domestic development of alternatives will take time and are likely to be inferior.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	2.8	2.2	-2.7	4.7	-5.0
Inflation (average)	2.9	4.5	3.4	6.7	14.0
Government balance/GDP	2.9	1.9	-4.0	0.7	-2.3
Current account balance/GDP	7.0	3.9	2.4	6.9	12.2
Net FDI/GDP [neg. sign = inflows]	-0.5	-1.9	-0.6	-2.3	n.a.
External debt/GDP	28.5	28.7	32.2	27.1	n.a.
Gross reserves/GDP	28.4	32.8	40.4	38.4	n.a.
Credit to private sector/GDP	51.2	52.6	59.8	55.0	n.a.

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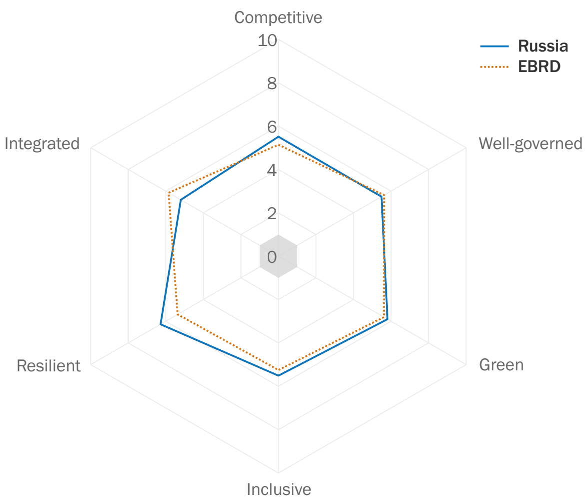
Macroeconomic developments and policy response

Russia's decision to invade Ukraine on 24 February 2022 resulted in the gradual imposition of widespread sanctions. The sanctions went much further than many had anticipated. Russia soon found itself cut off from much of the international financial system, with more than half of the central bank's international reserves being frozen. Other measures included: an embargo on exports to Russia of critical technological components, including semiconductors, and the direct sanctioning of more than 1,200 individuals. Beyond this, Russia has seen the withdrawal of more than 1,000 multinational companies in a form of self-sanctioning. Sanctions have also been imposed on the energy sector but these have been more limited initially, because some sanctions will not take effect before 2023 and Russia has been able to redirect exports to non-sanctioning countries. The economic impact has been significant, with gross domestic product (GDP) contracting 4 per cent year on year in the second quarter of 2022, the rouble depreciating by almost 50 per cent to more than 130 roubles per US dollar and inflation doubling to almost 18 per cent. However, after the initial shock of sanctions, the rouble rallied, and its October 2022 level of around RUB60/US$ is stronger than in the months before the invasion. This rally reflects the dissipation of the initial shock, the introduction of capital controls and the rise in the current account surplus as imports have collapsed and energy exports have continued to flow at high global prices.

Inflation has been brought under control. The central bank (CBR) was quick to respond to the inflationary impact of sanctions, hiking the policy rate from 8.5 per cent to 20.0 per cent over the course of a month. The subsequent strengthening of the rouble has had a disinflationary impact, helping to bring inflation back down to 13.7 per cent in September 2022, and weak consumer demand is likely to damp inflation further in the coming months.

The growth outlook is bleak. The impact of sanctions on activity has been severe, albeit not as bad as expected because of the CBR's policy response, the country's strong fiscal buffers and the resilience of the energy sector. But as far as the non-oil economy is concerned, in particular those sectors dependent on foreign imports, things look less positive. The economy is expected to contract by 5.0 per cent in 2022 and by 3.0 per cent in 2023. The growth outlook is likely to remain bleak in the absence of a peace agreement that results in a loosening of sanctions, and the economy's shift towards autarky and the loss of qualified workers to emigration mean that long-term growth potential will remain significantly eroded.

CHART Assessment of transition qualities (1-10)



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Structural reform developments

Structural reform has been extremely limited in 2022. Russia's war on Ukraine has left the country isolated and barred from accessing much western technology. This is hindering the country's ability to diversify away from oil.

Implementation of the National Projects scheme has slowed significantly. The ongoing conflict has resulted in a diversion of government expenditures, hampering progress in implementing the National Projects, a series of 13 large-scale infrastructure and social development projects set out by the president in 2019.

The authorities continue with their comprehensive review of business regulations, known as the "regulatory guillotine". This involves a review of more than 20,000 business regulations and requirements. Many regulations, some of which date back to the Soviet era, are being cancelled or replaced based on cost-benefit analysis. The scheme is expected to improve the business environment by cutting red tape and aligning regulations more closely with the needs of businesses.

* The EBRD announced on 4 April 2022 that, following the invasion of Ukraine, its Board of Governors had formally suspended Russia's access to EBRD funding for projects or technical cooperation.