Macro Notes – Russia: Economy to Contract Sharply in 2022

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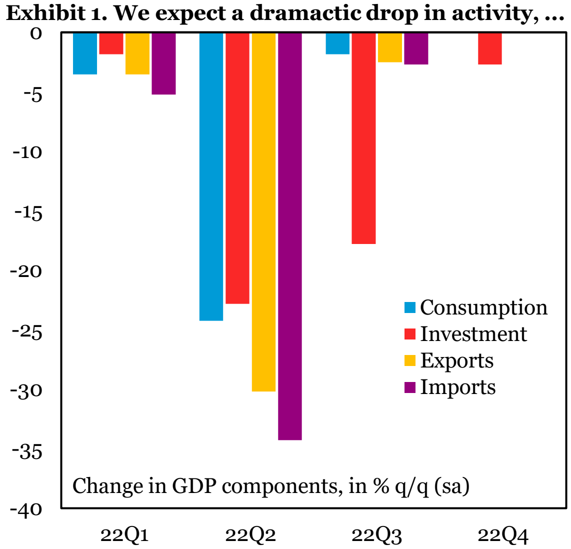
- We expect the Russian economy to contract by 15% in 2022 due to the war in Ukraine.
- Sanctions play an important role but so does *"self-sanctioning"* of foreign companies.
- Domestic demand will fall sharply, while a collapse in imports will offset lower exports.
- Together with a decline of 3% in 2023, this will wipe out fifteen years of economic growth.
- However, the impact on medium- and long-term prospects is likely to be even more severe.
- *"Brain drain"* and low investment will weigh heavily on already-subdued potential growth.

In this ***Macro Notes***, we attempt a preliminary assessment of the impact on the Russian economy from international sanctions and other developments following the country's invasion of Ukraine. The EU and U.S., together with other countries, have imposed a wide range of measures on critical sectors of the Russian economy as well as its government and central bank that will have a dramatic impact on economic activity. We believe it to be more likely than not that the military conflict will drag on and lead to further sanctions, including, potentially, on key exports such as oil and natural gas. Due to the unprecedented nature of the situation as well its extremely fast pace, any forecast will inevitably be surrounded by an unusual level of uncertainty. At this point in time, we expect the Russian economy to contract by 15% in 2022 as domestic demand drops substantially, while a collapse in imports will outweigh a sharp decline of exports and keep the contribution from net foreign demand in positive territory.

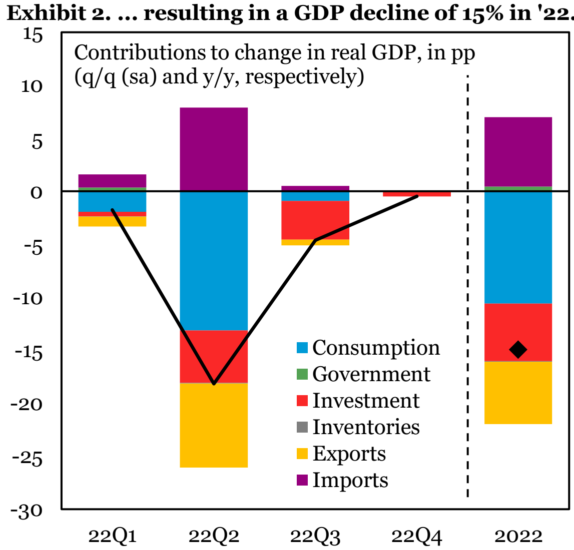
The impact on GDP components is expected to differ considerably, both in magnitude as well as sequencing (Exhibit 1). We believe that the impact on imports will be largest, as the significantly weaker Ruble drives up prices and both households and corporates are struggling to acquire sufficient foreign exchange. At the same time, foreign companies will reduce their acquisition of Russian goods considerably even in cases where they are not required to do so legally, a dynamic that can be described as *"self-sanctioning"*. With economic prospects dimming, both in the short as well as medium and long term, a dramatic decline in gross fixed capital formation is likely. However, this will play out over a longer time period since investments are usually adjusting to the overall economic outlook at a slower pace. Finally, while consumption is also set to decline markedly, it should stay somewhat more robust as households retain access to Ruble liquidity and, thus, purchasing power.

Exhibit 1. We expect a dramactic drop in activity, ...



Source: Rosstat, IIF

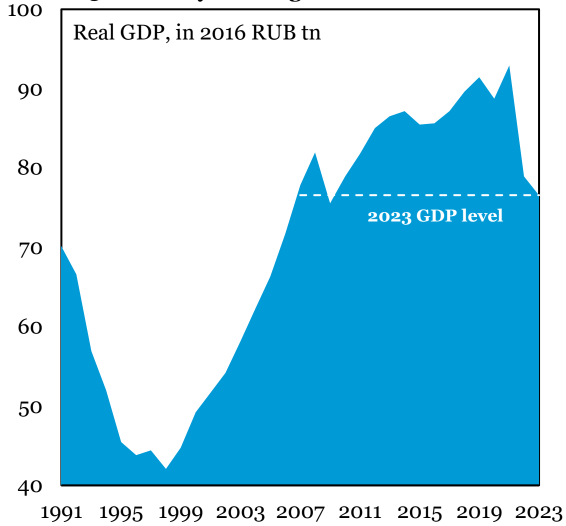
Exhibit 2. ... resulting in a GDP decline of 15% in '22.



Source: Rosstat, IIF

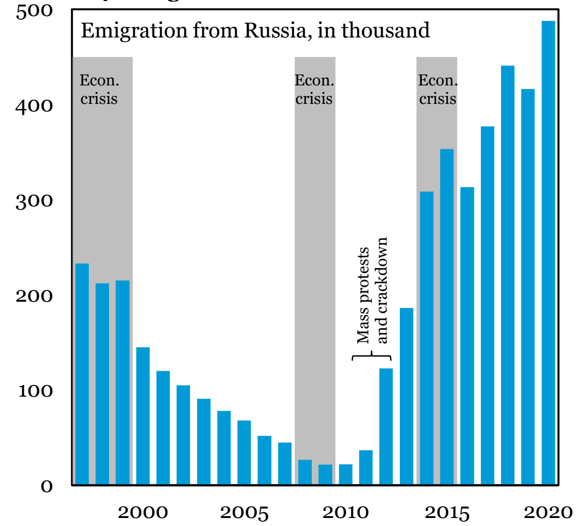
The impact on economic activity will largely be captured in 2022Q2 numbers given that sanctions were first imposed at the very end of February. Base effects will lead to additional negative growth across GDP components in 2022Q3 and, as far as investment is concerned, in 2022Q4. While consumption is relatively less affected, its GDP share of around 50% means that it will have the largest negative effect on growth (Exhibit 2). In our baseline scenario, we expect a small sequential activity uptick in 2023; however, a large negative carryover from the current year (-8pp) will result in a year-over-year contraction of 3%. Altogether, our projections mean that current developments are set to wipe out the economic gains of roughly fifteen years (Exhibit 3).

Exhibit 3. Fifteen years of growth to be reversed.



Source: Rosstat, IIF

Exhibit 4. Emigration continues to increase.



Source: Rosstat, IIF

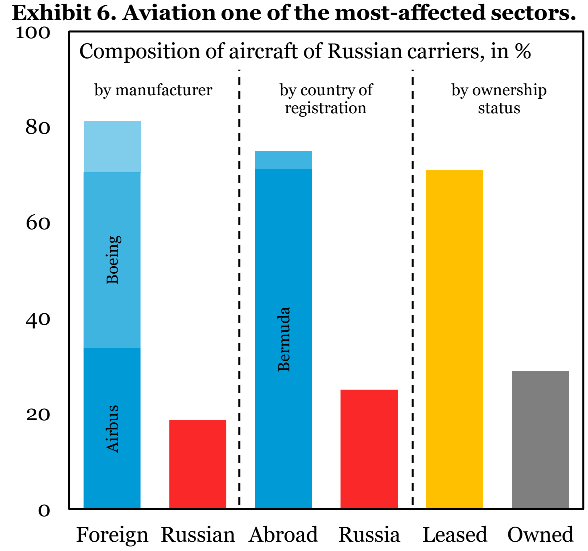
In this note, we also look at medium- and long-term implications of sanctions and related dynamics, including significant *"brain drain"*, lower productivity growth, and the *"self-sanctioning"* of foreign companies which will lead to a weakening of important sectors of the Russian economy. The war in Ukraine has already led to the largest refugee wave in Europe since World War II with approximately three million Ukrainians having fled their country so far (IOM) and approximately 100k doing so every day. However, Russia is also affected by emigration, especially among the educated middle class which has the necessary financial means. Some observers estimate that around 200-300k have left just in the last three-and-a-half weeks.

There is anecdotal evidence of flights to Turkey being booked up well into 2023 and a third daily train from Saint Petersburg to Helsinki was just added to accommodate the high demand. The resulting *"brain drain"* is not a new phenomenon, however. Following the *"golden period"* of economic expansion and double-digit real income growth in the 2000s, emigration accelerated again following Vladimir Putin's return to the presidency in 2012 and continued in the aftermath of Russian military action in Ukraine in 2014 and the imposition of international sanctions (Exhibit 4). According to official statistics, almost half a million people left Russia in 2020, close to double the numbers during the economically challenging 1990s. This *"brain drain"* is one of the reasons why we believe that productivity and potential output growth will decrease further from already-low levels (Exhibit 5). Another reason is U.S. and EU export controls on technology, including microelectronics, which will hinder technological development for years.

Exhibit 5. Productivity growth has been weak.

Source: Rosstat, IIF

Exhibit 6. Aviation one of the most-affected sectors.



Source: planespotters.net, IIF

An important dynamic that we have observed since the beginning of Russia's invasion of Ukraine is what can be described as the *"self-sanctioning"* of foreign companies. The strong shift in public opinion in recent weeks has prompted a significant number of corporates (more than 400 according to the latest estimates) to withdraw—partially or fully, temporarily or permanently—from the Russian market even in cases where they were not required to do so under international sanctions. This includes manufacturers, e.g., in the automotive sector, energy companies, large retailers, financial institutions, as well as other service providers such as law and consulting firms. While the immediate impact on economic activity will be considerable, we expect it to be even more meaningful in the medium and long term and lead to a permanent weakening of key sectors of the Russian economy. At the same time, the retreat of foreign competitors will provide opportunities for domestic companies to fill the gap, resulting in an increasing decoupling of Russia from the global economy—*"Fortress Russia"* pushed to the extreme.

The energy sector is an important example of the long-term implications of foreign companies' exit. Since 2014, foreign companies had already been banned from investing in new oil and natural gas projects. But multinationals have also pulled out of existing joint ventures with Russian companies in recent weeks. While this may not have an immediate impact on production and export capacities, the sector will eventually lack the necessary investment to maintain infrastructure and continue with the exploration of so-far untapped resources. Another sector that will be disproportionately affected is Russia's aviation industry. Following the invasion of Ukraine, Airbus and Boeing—which represent around 70% of the close to 1,000 aircraft flying for Russian carriers (Exhibit 6)—canceled maintenance contracts and stopped spare part deliveries. Experts believe that roughly half of all planes could be grounded by next year due to these actions. Another issue is that Bermuda recently invalidated all aircraft registrations in the country which affects more than 70% of Russian-operated aircraft. Finally, more than 70% of all planes are leased, overwhelmingly from international leasing companies, and sanctions mandate all contracts to be terminated at the end of March.

To summarize, the Russian economy is going to be hard hit by international sanctions and related developments. This year, we expect output to contract by 15%, followed by a statistical-carryover driven further 3% in 2023, which will wipe out economic growth achieved over the last close to fifteen years. Sharply lower domestic demand is likely to play a crucial role while a collapse in imports should offset lower exports, leading to a marginally-positive contribution from net foreign demand. However, should further sanctions in the form of trade embargos be implemented, exports might fall more than we currently forecast. In addition to the near-term implications, we believe that the negative effect on medium- and long-term economic prospects could be even more important.