

Ep. 187 - Russia's economy today

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Call Participants

ATTENDEES

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Presentation

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Kristen Hallam

Russia's economy seemed to show remarkable resilience in the face of waves of sanctions that followed its invasion of Ukraine. But recently, the Bank of Russia had to take steps to shore up a weakening ruble. Are the sanctions finally biting? And how much of a bite would it take to get Russia to the negotiating table. I'm Kristen Hallam, Content Strategist at S&P Global Market Intelligence and your host for this episode of the Economics & Country Risk podcast. Joining me to discuss Russia's economy is Lilit Gevorgyan, Associate Director, Europe and CIS Economics at S&P Global Market Intelligence. Lilit, welcome to the podcast.

Lilit Gevorgyan

Thank you, Kristen. Thank you for inviting me.

Question and Answer

Kristen Hallam

Lilit, tell us about what is going on with the ruble. What was significant about the actions of the Bank of Russia?

Lilit Gevorgyan

Well, the Russian ruble has been making headline news in recent weeks after its exchange rate collapsed in mid-August to levels unseen since the Russian invasion of Ukraine. Now this is an important development because it's a blow to Russian authorities' claim that they're not really impacted by Western sanctions.

It is true that despite the sanctions, the ruble's exchange rate was quite strong. In fact, it was the strongest in 8 years throughout most of the last year and early 2023.

Kristen Hallam

Wow.

Lilit Gevorgyan

But the fact is it has -- but the fact is it's not because the Russian economy was booming. It's because the Russian economy was in crisis management mode because the Russian central bank had imposed currency controls and tight monitoring conditions.

Now Russian consumers are perhaps not too sensitive to the news from the Ukrainian front lines, but the ruble weakness is something that they are sensitive towards because it hits their pockets directly. Why? Because a weak ruble translates into import price inflation, and it puts pressure on their disposable incomes that have been already under pressure for several years now.

Now RUB 100 per USD 1 is a psychological mark for many Russians and businesses. Therefore, when the exchange rate crossed that threshold in mid-August, the Bank of Russia just jumped to stop the currency collapse.

Kristen Hallam

The downward shift in the ruble that you've described, does that indicate that sanctions are hurting the economy now?

Lilit Gevorgyan

Absolutely, sanctions are hurting Russian economy without any shadow of doubt, and this negative impact is very much apparent in ruble's volatility in recent months. I have to say that there are several factors at play, and most of them are linked to sanctions.

So what is really hurting the ruble? Firstly, Russian energy export-generated revenues are falling because of the tightening embargo on Russian crude oil and oil products that was -- the embargo that was imposed by G7 countries. See, although the crude oil market prices globally are rising, they are no longer supporting the ruble. In the past, when the crude oil prices were rising, the ruble was strengthening. Now that positive correlation is broken. That is an impact of the sanctions.

Second, the Western sanctions have left Russia with no choice but to move from EU to Asian markets, and they have to do this fast. And sanctions disrupted supply routes that Russia had established for the past 3 decades. And at the moment, you're trying to establish new supply routes. Now it might sound strange, but one might say that perhaps Russia was too successful in establishing this new supply route, and that has also increased the domestic demand, especially for Chinese imports. And that as a result, the demand for yuan has increased, and that had undermined the ruble.

At the moment, 80% of Russia's banking sector by assets are under U.S. sanctions, including top 10 Russian-owned banks. That means that using the dollar is problematic for Russian banks. Therefore, Chinese yuan has emerged as the most favored currency for cross-border settlements. What does this mean? This means that there is an increased demand for yuan, again, and that is putting further pressure on the ruble.

Another source of pressure for the ruble has been the so-called fiscal rule. Now Russia has a fiscal rule, and that restricts the use of the oil and gas windfall. The implementation of this rule undermined the ruble as well because the Finance Ministry has been carrying out regular currency market operations to beef up their sovereign wealth fund. It's called National Wealth Fund, which had about USD 140 billion at the start of September. So that has also resulted in the ruble weakness.

So not only the Bank of Russia stepped in and increased the key lending rate, but they also decided to stop buying foreign currency in the domestic market until the end of 2023 to give the ruble some breathing space.

Kristen Hallam

I definitely want to come back to the currency discussion and the yuan. But before we go there, can you tell us why we haven't seen the impact of sanctions really up until recently? Have the results of the sanctions been masked up to this point? And how do you go about unmasking them?

Lilit Gevorgyan

I would say that the impact of the sanctions have been somewhat masked because Russian economy fell only by 2.1% last year, in 2022. Now this is a relatively mild rate of contraction compared to consensus expectations that was at least 4%, 5%.

Kristen Hallam

Yes.

Lilit Gevorgyan

For Russian authorities, this was a really a PR coup in some sense because they were showcasing that despite this unprecedented level of sanctions, the Russian economy has shown resilience and that they can actually withstand these sanctions. There are different reasons why the contraction was relatively mild, and there's not much room for optimism for Russian policy makers.

Well, first of all, I think it was because of the record high energy prices. That helped Russia. Second, there was a delayed implementation on Russian energy sector and exports in 2022. The decisions were made, but they were implemented only by the end of 2022 and early 2023. And this has really contributed to better results or relatively mild contraction last year.

Another fact is that the exodus of international businesses, it doesn't really happen overnight. Therefore, the negative impact on business activity, investment activity, this will take some time to take effect. So there is some lag there as well.

Data can also be misleading. There are also concerns about the accuracy of the data. Now for example, Russian statistics office, Rosstat, is reporting a record low unemployment rate. Currently, it's around 3%. Russia has never had such a low rate of unemployment since the collapse of the Soviet Union.

However, this tight market, labor shortages, are not because of the booming economy but because of the mass exodus of skilled labor, impact of the military mobilization, the fact that the weakening Russian economy and Russian ruble makes the country less attractive for guest workers mostly from Central Asia. In addition, there's also a risk that some of these guest workers may be recruited and sent to Ukraine. So that's another disincentive for them to move to Russia for seasonal work. So you can see that the numbers that may look very strong and positive on paper -- there's another story and explanation behind that.

Kristen Hallam

So let's go back to that discussion about currency and about the yuan. At the recent BRICS summit, de-dollarization was a popular topic, although no actions were taken on it at the summit. And Russia is a proponent of de-dollarization. Why is that?

Lilit Gevorgyan

Russia sees the de-dollarization as a necessary move to lessen its vulnerability vis-à-vis the collective West. It wants to achieve some sort of financial autonomy. But that said, they didn't really make much progress until only recently. Most of their reserves up until recently remained in U.S. dollars and euros. Energy trade was done using the U.S. dollar or euro.

But now the de-dollarization is happening at a really high speed, but that's because it's an imposed choice for Russia. This is because most of its systemically important banks are cut off from Swift international payment system. Over 60% of Russian central bank's foreign exchange reserves are frozen in G7 countries. Its strategic sectors are under Western trade restrictions. So that means that using dollar has become very difficult, almost impossible.

So Russia has been working towards replacing the dollar in Europe with ruble as the main payment currency for its exports to Mainland China, Turkey, Kazakhstan and India. These four have emerged as Russia's top trade partners since the war started with Ukraine. Now Russia wanted to use the ruble with EU as well, but these demands largely failed.

By contrast, Russia has made more progress in de-dollarization with BRICS countries and also with Turkey. For example, unlike the EU, Turkey agreed to pay in rubles for Russian energy imports. Meanwhile, several Indian refineries have been using Chinese yuan rather than Indian rupees to pay for Russian crude imports.

According to Russian officials, and I think this was also confirmed by the Russian President recently, 80% of Russian-Chinese trade is now settled in yuan and rubles. This is what de-dollarization looks like. Also, according to Russia's central bank, the share of Russian exports to BRICS countries that are invoiced in U.S. dollars have sharply fallen. And by that, by sharply, I mean, from 95% in 2013 when they were invoiced in U.S. dollars, by the beginning of 2022, it was only 10%.

Kristen Hallam

Wow.

Lilit Gevorgyan

This is a huge progress, yes.

Kristen Hallam

That's big.

Lilit Gevorgyan

But having said that -- yes, it is quite big. But having said that, Russian de-dollarization efforts, they will be restricted by major obstacles. And that major obstacle is the convertibility of these other currencies that are being used. They're not really used as stores of value. So that is going to have a restrictive and negative impact on Russian external trade.

Kristen Hallam

Interesting. De-dollarization, I think, is one issue that we'll continue to explore in this podcast given the momentum that is going on around this issue. And as you noted, in practice, it's also accelerated. Maybe we'll have a separate episode on that topic.

Lilit Gevorgyan

Yes, why not, why not.

Kristen Hallam

Why not. So does this increased trade in yuan, does that mean that Russia's economy is more dependent on Mainland China now compared to what it was before the war in Ukraine? And what are the implications of that?

Lilit Gevorgyan

Obviously, Russian economy is becoming far more dependent on Mainland China than, I would say, Russian policymakers and Russia, in general, would like to. But I don't think they have many choices at this stage. Also, I have to say that Russia has always had an uneven economic relationship with China even before the Ukraine war, and now it's getting worse for Russia in some ways.

So China's share in Russia's trade is around 20%, 22% currently. But for China, Russia is basically a junior trade partner. It's mostly a source of commodity imports. So as a result of the sanctions, now Russian businesses are sourcing about 60% of imports from China. Semiconductors, dual-use goods that are sanctioned by the G7 countries are perhaps the most prized import that Russia is now seeking from Mainland China.

The Russian sovereign wealth fund reserves, 60% of them are now kept in yuan. This is also increasing Russia's exposure to China. In early 2023, for the first time in the history of Moscow Exchange, the yuan overtook U.S. dollar as the most traded currency with a market share just about 40% of trading volume. That is impressive, yes. Last year, 2022, Chinese investments in Russia increased by 150%, and I think this trend is likely to continue. But that said, overall, Chinese investment levels remain relatively modest in Russia.

Kristen Hallam

It will be interesting to see what those investment levels do over time because it looks like this war is going to go on for some time. Our current outlook for the war is that it will be a long one. What would it take in terms of economic pain for Russia to come to the negotiating table with Ukraine?

Lilit Gevorgyan

Yes. That's the most asked question, and I would say a lot. But to start with the long war assumption, indeed, that's our assumption that this war is going to last for some time, at least 2, 3 years under current assumptions or within that period. During this period, we will see that Russia's economic decoupling from Western market will deepen. Russia has to

undergo structural economic changes to adapt to the new realities. Unless there is a major shift in Russian foreign policy and full reset of relations with the West, these sanctions -- heavy sanctions are going to stay.

Therefore, we'll continue seeing intensified import substitution drive or more reliance on China. We will see sort of rerouting of supply chains and changing the external trade patterns. We think that Russian real GDP will rebound this year by 2.5%. So the real GDP will expand by 2.5% after falling 2.1% last year. But this is mostly because of government spending, and government spending is driven by the war spending. So Russia has doubled its defense spending in 2023, this year, to USD 100 billion.

In the medium term, we are going to see growth below 2% year-over-year despite the government spending, and this is not enough for Russian economy to keep the pace or expand and modernize. This is very weak growth for Russia.

A prolonged war, coupled with increased risks of domestic instability -- and by that, the unprecedented mutiny that we saw, right, Wagner private military company, we're seeing rising number of security incidents within Russia linked to Ukraine war -- these are all likely to contribute to further capital outflow and business relocation from Russia. Business confidence of Russian and non-Western investors operating in the country remains low and is likely to remain low for several years to come.

So what will bring Russia to the negotiating table? Only prolonged currency crisis, collapsing export and export-generated revenues perhaps over a period of 12 to 18 months, perhaps. Because as I said, Russia is a large market, and it's a resource-rich market and it can be self-sufficient in some ways. Therefore, these pressures do not necessarily mean that it will translate into immediate softening of Russian negotiating position because of the political system.

Even if the economic hardships increase, there are no channels that will translate that displeasure or discontent from ordinary citizens into political change. Therefore, I don't -- at least short term, I don't really see economic hardships softening Russian position, especially given at the moment, Russia is establishing new trade partners and trading routes.

Technological starvation, so to speak, and slow but steady decline in business and infrastructure investments, they are most likely to undermine Russian economic potential and military capacity for many years to come. So they will have an effect of deterrence, but I don't think that an immediate softening of position is on the cards now.

Kristen Hallam

Understood. As you noted, the Russian economy is composed of many moving parts, lots to keep an eye on there. What are the main signposts that you'll be watching for in the next, say, 6 to 12 months?

Lilit Gevorgyan

The ruble. I will be watching the ruble.

Kristen Hallam

We're going back to where we started, with the ruble.

Lilit Gevorgyan

Yes. It is important because currency is more sensitive to developments, and the ruble's vulnerability can translate into more trouble for the economies. So I will be watching the ruble's performance, and I think it will remain vulnerable to several of the risks that I highlighted earlier. And I think there's another rate hike on the cards of the central bank. It's most likely that the key rate will be lifted to 13.5% by the end of this year.

I will be watching the dynamics of Russian energy export, which I have seen they started declining. For example, Indian crude imports from Russia have fallen to a 7-month low this month. This is quite a negative development for Russia.

I will be watching how effective are the U.S. and EU coordinated actions to stop, to curtail the transfer of sanctioned goods to Russia. This is a very important factor actually to watch because it will have an impact on the performance of several strategically important sectors of Russian economy, such as energy production, aviation, transport and in general, wider manufacturing sector. So I'd highlight these for the moment.

Kristen Hallam

Well, thank you so much, Lilit, for illuminating these topics for us. And thank you, our listeners, for joining us. Let us know what topics you want us to cover by interacting with us on the S&P Global Market Intelligence social media handles and join us next week for a discussion of the supply chain outlook for Q4.

Announcer

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