Good News and Bad News for the Russian Economy

by Ekaterina Zolotova - October 31, 2022

Years before the Russian war in Ukraine – in fact, years before Russia was even under sanctions – authorities in Moscow faced criticism from their constituents for “selling” the country’s resources and companies to foreign interests. The concerns were well founded: Foreign chains entered the market, gradually gained popularity and eventually conquered their markets, however niche, oftentimes becoming the largest companies in their respective industries.

Today, many of these companies are leaving, sometimes selling their businesses. The silver lining for Russia is that this allows Russian entrepreneurs to fill the void, even as businesses can skirt sanctions by importing goods from third-party countries. And so, after eight months of war, Russia seems to be adapting to new realities but continues to face logistical difficulties and general uncertainty, as evidenced by slowing production indicators and scrupulous preparation of upcoming federal budgets.

Better Than It Looks

Russian sanctions have been in place since 2014, but rarely did they affect the daily lives of ordinary citizens. The lone exception was agricultural products, which were replaced easily enough by domestic production and imports from Eurasian Economic Union countries. All the while, international companies continued to operate and even open new branches. Still, Moscow took steps to substitute imports of sensitive goods, knowing that the conflict in Donbas – which was largely responsible for the imposition of sanctions in the first place – was unresolved and any intervention in it could lead to tougher sanctions.

But the new sanctions levied after the invasion were much more severe in that they dramatically reduced what Russia could import. (Exports were comparatively less affected. In terms of value, they remain at high levels thanks to rising prices for raw materials and energy resources and to the pivot to Asian markets to offset losses in Europe.) According to preliminary estimates from Russia’s central bank, imports will fall by 32.6-36.5 percent by the end of the year. Meanwhile, foreign businesses took flight. By October, some 317 global companies left the Russian market, the most notable of which included Ikea, McDonald’s and Coca-Cola, which had a fairly large number of employees and some infrastructure and factories in Russia. Almost all major participants in the automotive industry have suspended operations at their production facilities. The disconnection of the SWIFT payment system, ideological disagreements with Moscow and, most important, logistical difficulties with the delivery of goods have called into question the prospect of conducting business in Russia henceforth.

It's not an ideal situation for Russia, of course, but it's not as bad as it may sound. For one thing, not all companies completely stopped their activities. Some either reduced investment and marketing programs, or temporarily froze operations until the dust settled. Many of those that have left have been replaced by Russian businesses. For example, Russian companies have replaced departed soft drink makers and restaurants, and Russian clothing brands have even found their way to the market. And naturally, these businesses employ workers the same way the old ones did. The formula for success seems to be to focus on the domestic market, shore up a little money, capitalize on good connections with countries in the post-Soviet space and, as important, be creative.

For another thing, some companies that left the Russian market in 2022 are already returning, even if they must do so under a different name. Reebok, for example, has made its way back under the auspice of a Turkish holding company called FLO Retailing Turkey.

Finally, businesses have created parallel imports and have used them effectively. In fact, after sanctions were imposed there was a marked increase in exports with trade partners in Russia's near abroad. In the first half of 2022, exports from Armenia to Russia **increased by 49 percent compared to the same period last year**. Georgia increased trade turnover with Russia by roughly 50 percent while increasing exports to Russia by 11 percent. Imports from Kazakhstan rose by 30 percent. In other words, Russians can still buy an iPhone 14 or spare parts for their cars, and drink Coca-Cola, and fly out of the country using the services of other airlines.

Threats Remain

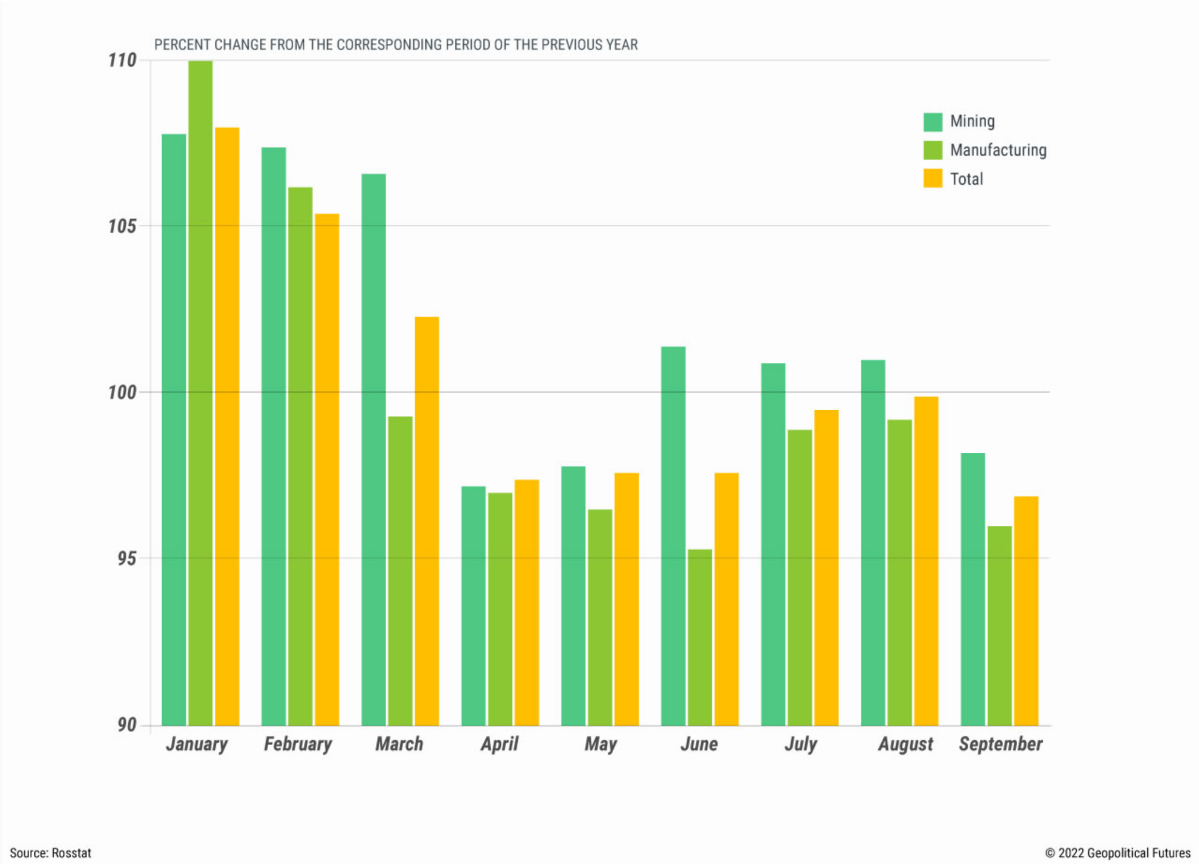
Even so, Russian industry isn't out of the woods. In 2020-21 Russia recorded an increase in dependence on imports. The share of imports for non-food consumer goods such as clothes, shoes, appliances, cosmetics, etc. ranged from 40 percent to 90 percent, depending on the industry. (This ignores the fact there are simply no alternatives to some lost imports.) And there has been severe damage caused by the restriction to export products that Russia produces inefficiently: electronics, computers, components for the aerospace industry and other IT products. Even parallel imports cannot offset the damage. For example, because some foreign distributors have stopped cooperating with Russian partners, Russian companies have begun to import microchips through unofficial suppliers, often with poor results: As much as 40 percent of the microchips they receive from China are defective, compared with 2 percent before sanctions. (Anecdotally, this has prevented Russia from introducing a new 100 ruble banknote into circulation because only 20 percent of ATMs can accept them.)

Moreover, new Russian businesses have been unable to recoup all the jobs lost by departing companies, which created work throughout the entire production line, employing drivers, cleaners and so on. Decreased production will magnify these losses. McDonald’s accounted for about a quarter of all taxes paid by the food services industry, and its share of local purchases of raw food materials, food products, packaging, and cleaning and detergents **once reached as high as 90 percent**, thus providing 100,000 jobs at suppliers’ enterprises. Enough time has passed since the closing, sale and launch of the restaurant chain under a new brand to create trouble for those who worked directly or indirectly for the chain. Larger, more established companies like Mcdonald’s can withstand things like decreased demand, declining real wages due to inflation, and consumer reluctance in the face of uncertainty better than their replacements can.

It’s no surprise, then, that the threat of bankruptcy looms, even if it is not visible in state statistics. Bankruptcy growth rates decreased in January-September 2022 due to a moratorium on bankruptcy, but analysts nonetheless predict a wave of bankruptcies in 2023-24, including among large enterprises and even entire industrial groups. The cause: the general accumulated negative effects of the COVID-19 pandemic, the 2022 sanctions, the departure of an active and solvent population abroad, and the general drop in supply and demand in different markets.

This is reflected in the indicators of economic development. Industrial production decreased by 3.1 percent in September compared to September 2021 – the largest decline in two years. An even bigger decline was seen in manufacturing industries such as coal mining, metal ores, and even oil and natural gas production.

Russian Industrial Production Indices, 2022



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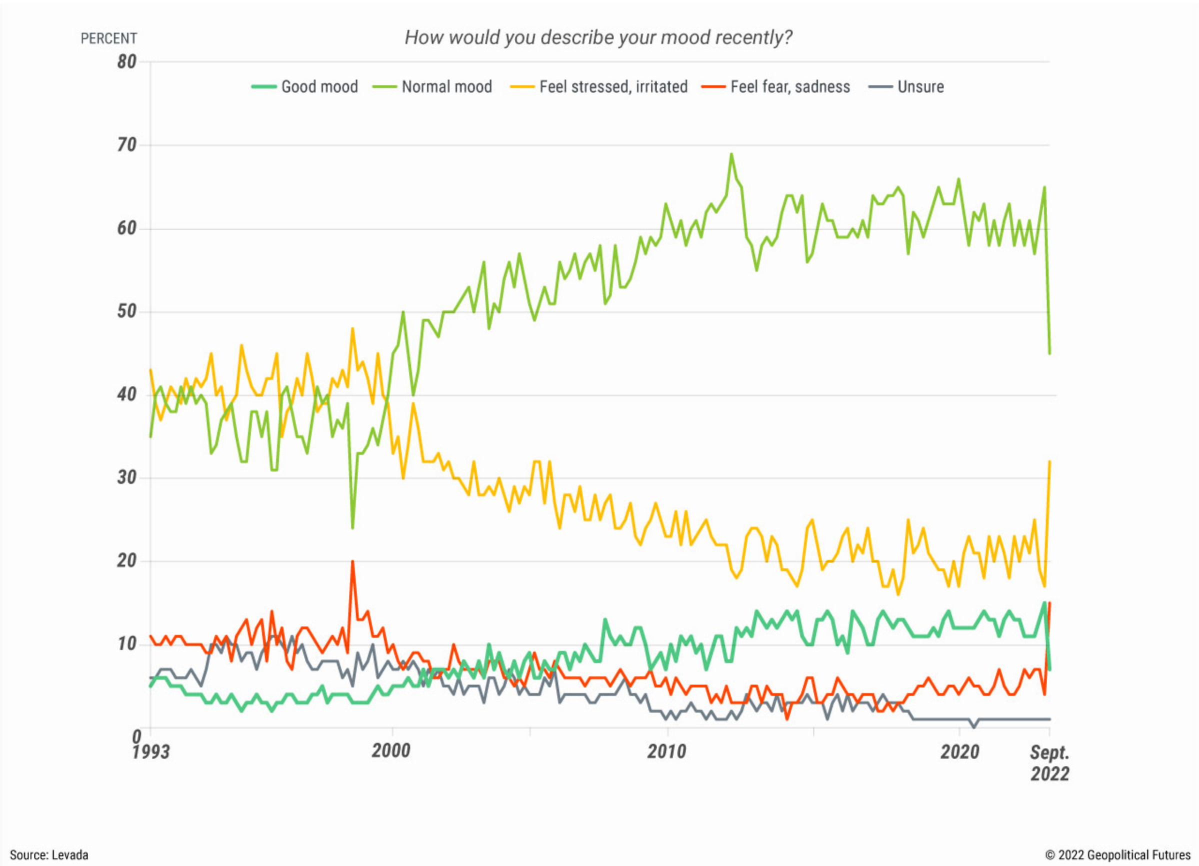
Implications

The implications of Russia's economic decline are many. One of Moscow's most urgent geopolitical imperatives is to unify, as best it can, the largest landmass in the world, often redistributing income and subsidizing key industries to do so. The biggest threat to the Kremlin, then, isn't NATO but the population itself. Russians remember all too well the economic calamity of the 1990s, and the fear of reliving it compels ordinary citizens to stock up on things like buckwheat and toilet paper, and to distrust banks and overreact to everything from a new wave of coronavirus to a possible nuclear attack, which puts even more pressure on the economy, government and infrastructure. **According to a survey conducted by the Levada Center**, public sentiment has deteriorated sharply. Tension, anger, fear and melancholy are rampant, at levels not seen since 2000.

Russian Mood Score



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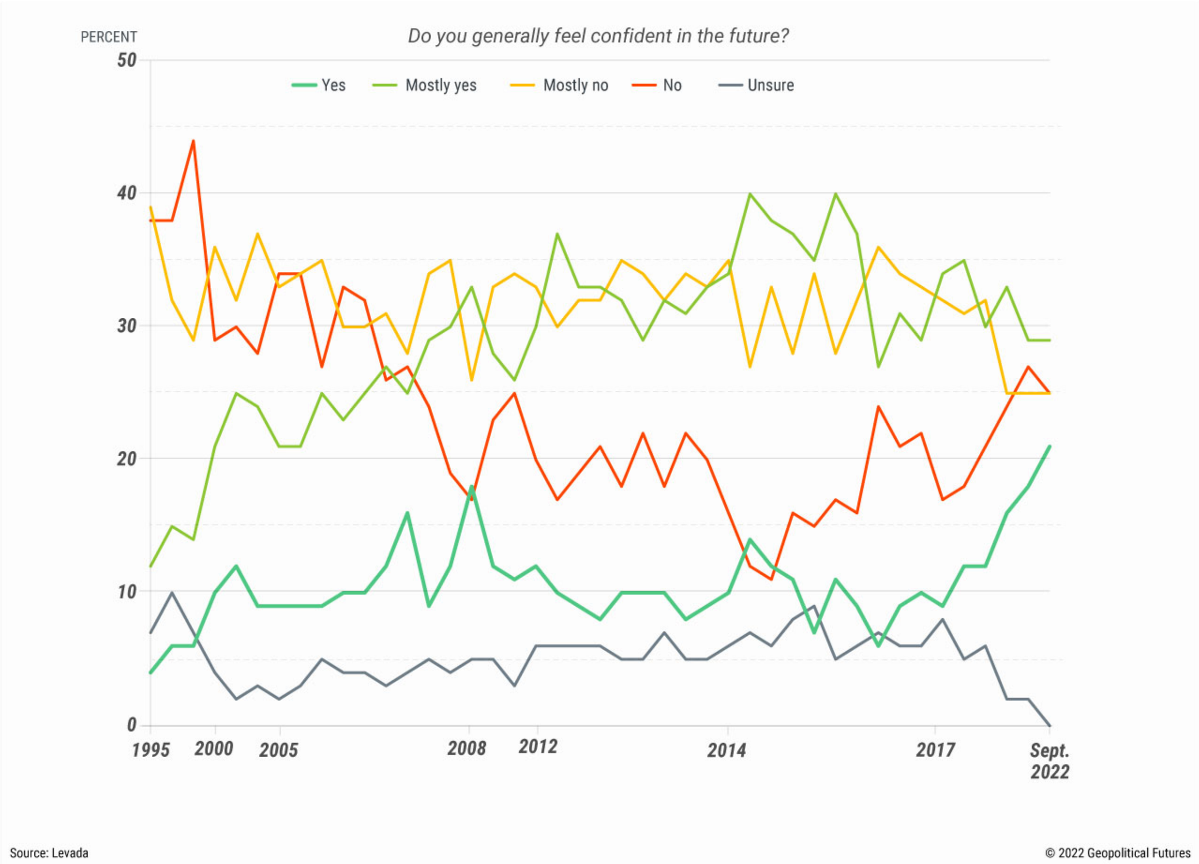
Russian Confidence in Future



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This means that by the end of the year, the Kremlin will be facing three key challenges: completing a costly military operation that could damage, at least, the reputation of Russian leaders; coping with growing stress among the population and businesses alike; and diversifying exports. Each of these areas requires massive efforts and funding. The Kremlin understands that the Russian economy is entering a period of recession but expects it to be followed by a smooth exit, which will require investment and spending.

In the meantime, it faces the more immediate, more difficult task of planning the next few budgets amid a costly war, struggling businesses, an unhappy population and reduced imports.

There are many questions, and just as many opposing answers, about how to build the future economy. Some have proposed a State Defense Committee to lead all military and economic issues. But with a limited budget and the need to redistribute resources between regions, save bankrupt industries and solve social issues, the militarization of the economy looks like an extremely expensive solution, not to mention the socio-economic consequences inherent in such an enterprise. The Kremlin has no choice but to make sure it has enough funds to overcome all three problems simultaneously. This is no easy thing, and obviously the Kremlin is in no hurry; it’s biding its time, hoping the war in Ukraine tips in its favor. The most dangerous prospect will not be a budget deficit but an imbalance in all three areas, which will create an imbalance in the economy and in society.

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