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Cross-Asset- and Strategy-Research

Russia: the economic wheels are coming off

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Why Wladimir Putin's economic miracle is faltering

Today's discussion will not focus on Trump's erratic trade policies, but rather on another factor that has shifted since the change in administration: America's stance towards Russia. Trump is generally considered to be rather friendly towards Russia. As far as the war in Ukraine is concerned, the Trump team noticeably [sided with Putin](#).

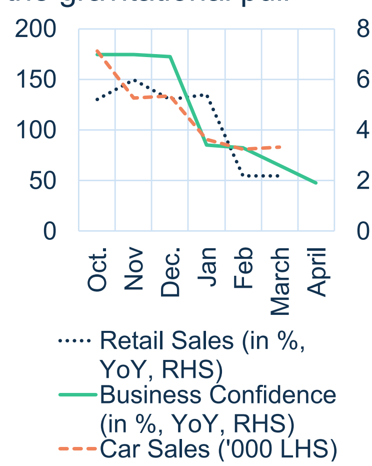
Russia's economy faces headwinds

One might assume that the Russian economy would thus benefit from the improved relations with Washington. With a new ally in the White House, you might think there should be nothing standing in the way of continuing the surprisingly strong growth of over 4% in 2023 and 2024! Alas, you'd be mistaken! In reality, Russia's economy is in a nosedive. A crash landing is not inevitable, but it has now become a distinct possibility.

Wherever you look: all early economic indicators are pointing south, and I don't mean the sunny resorts on the Russian Black Sea coast. Business and consumer confidence, vehicle registrations, retail sales: all are in accelerated reverse (see figure).

All indicators in the red

Russia‘s economy feels the gravitational pull



Source: Trading Economics, LBBW Research

The military-industrial complex has reached a peak

What has changed since I last discussed Russia in this column? Just half a year ago, everything seemed to be running smoothly! Well, in addition to Russia's inherent structural growth impediments such as dependence on the oil and gas sector, demographic decline, and widespread corruption, several cyclical factors have emerged. The years since Russia's attack on Ukraine were marked by Western sanctions and the reorientation of trade routes to the East. This required significant investments in the corresponding infrastructure, which boosted growth. This transformation is now largely complete.

The same goes for the arms industry. After the massive expansion of weapons and war goods production, a plateau has now been reached. At a very high level: last year, Russia spent more than 7% of its GDP on armaments, compared to about 4% before the war of aggression. But military output now appears maxed out. Additional growth of the military-industrial complex will be much more subdued from here.

The previous growth impulses are fading

Restrictive monetary policy

Inflation has risen to over 10%, far beyond the central bank's target of 4%. This is less due to patchy sanctions leading to supply constraints, but rather to rising labor costs, as workers are becoming increasingly scarce due to military conscription, casualties and emigration. The central bank has responded robustly by raising interest rates to a dizzying 21%. This has dampened economic dynamism.

High real interest rates are weighing on demand

Oil prices keep falling

And now, bad luck has also struck: thanks to Trump's trade war and the expected slowdown in the global economy hitting oil demand, oil prices are dropping sharply. Last week, the price of a barrel fell below $60, the lowest level since the pandemic. A year ago, oil cost around $80. And Russia needs at least this level to balance its budget. Public debt is not Russia's core problem.

But the current situation will undoubtedly lead to further erosion of Moscow’s fiscal space. Whether the economic predicament will lead to an escalation of Russia’s so-called “special military operation” in Ukraine also depends largely on Vladimir Putin's buddy in the White House. So far, his boastful peace promises have unfortunately remained unfulfilled.

“Russia is a gas station masquerading as a country”

John McCain

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