Does Russia have enough money for war?

Description

RUSSIA: Even with the Western sanctions and an expected drop in oil and gas revenues, Russia, unfortunately, still has money to continue its aggression on Ukraine.

It has been nine months since the Russian army launched a full-scale invasion of Ukraine. What was intended as a quick military operation to topple the Ukrainian government has now turned into a protracted war that has claimed tens of thousands of military and civilian lives.

Although the war is being fought on Ukrainian territory, which is suffering the heaviest human and material losses, Russia has also faced severe challenges that are affecting its economy.

The European Union, the United States and their allies have imposed a series of sanctions on Moscow, targeting government officials, imports and exports, heavy industry and oil and gas revenues.

Many experts believe the sanctions will significantly affect the Russian economy and thus force the Kremlin to halt its war of aggression. However, my analysis of the Russian state budget shows that such assumptions do not reflect reality. Moscow will not experience significant economic constraints in the short term that could force it to change its policy.

Sanctions and windfall profits

Economic sanctions imposed by Western countries have led to an economic decline in Russia, but perhaps not as big as many expected. According to the Russian government, in 2022, the GDP will fall by about 2.9 percent and the Central Bank says it will fall by 3 to 3.5 percent, or half of what some experts calculated back in March.

Shortly after the sanctions were imposed, Russia faced a surge in inflation. Consumer prices rose by 10 percent in the eight weeks after the invasion, but by May, they levelled off.

The Russian rouble also dipped significantly in February and March from 75 roubles for a dollar to 135, pushing up inflationary expectations and increasing panic among the general population. Realising the danger of continued devaluation, the Russian authorities imposed severe financial and currency restrictions on current and capital transactions. The rouble eventually fell to 50 for a dollar and stabilised at 60.

The Western sanctions, alongside falling demand, also led to a significant reduction in imports to Russia; they fell by 23 percent and 14 percent in the second and third quarters of 2022, respectively. This, in turn, has resulted in a 20 percent fall in budget revenues related to imports – including taxes and customs duties – in the first 10 months of the year.

The confrontation with the West over the war in Ukraine also affected Russia's hydrocarbon exports, which in 2021 accounted for nearly 50 percent of total exports and 45 percent of federal budget revenues. Even before the Russian invasion, Gazprom had started reducing its gas supply to Europe in 2021, which resulted in a price spike.

In April, President Vladimir Putin signed a decree requiring payments for Russian gas by European companies to be made in roubles only. A number of European countries refused to comply and gas supplies to them were halted. In April and May, the flow of Russian gas through the Ukrainian pipeline system and the Yamal-Europe pipeline via Poland was also disrupted. Then sabotage of the Nord Stream pipeline cut off gas to Germany in September.

Thus, by mid-November, Gazprom's exports to Europe (including Turkey) decreased by 43 percent. The company – Russia's biggest gas exporter – cut production by nearly 20 percent.

But this did not lead to a fall in revenue; on the contrary, Gazprom and the federal budget have seen a windfall in profit due to the sharp rise in gas prices. In August, at the peak of this trend, gas prices were up 460 percent year on year.

Gazprom's profits increased so much that the government introduced a temporary tax on its revenues from September to November, bringing 1.248 trillion roubles ($20bn) into the state coffers.

The situation in the oil sector has been similar. The EU's plan to introduce restrictions on imports of Russian oil and petroleum products forced Russian companies to look for new consumers and agree to a significant discount on the price – as high as 25 percent.

However, due to high oil prices, reaching $120 in the spring and summer, the price of Russian oil was still higher than in 2021, even with the discount.

Overall, in the first 10 months of 2022, Russia saw a 34 percent increase in budget revenues from hydrocarbon production and exports compared with 2021.

The cost of war

While high prices of hydrocarbons have resulted in high revenues, the Russian budget has also seen a sharp increase in military expenditures this year.

In mid-September, the Ministry of Finance reported that by the end of the year, defence spending would increase by 31 percent from 3.573 trillion to 4.679 trillion roubles ($57bn to $74bn). This includes the additional 600 to 700 billion roubles ($10 to 11bn) that the defence ministry is spending on purchases and repair of weapons this year.

Another item on the federal budget that saw an extraordinary increase in 2022 is “General National Issues”; it jumped by 50 percent to 2.629 trillion roubles ($42bn). Expenses under this title normally come from administrative activities of all branches of the government. If one supposes that the excess funds in this item are related to the war, then that’s an additional 869 billion roubles ($13.8bn) of defence spending.

Federal spending for the security apparatus has also increased by more than 19 percent compared with 2021 to 2.788 trillion roubles ($44.5bn). Some of these extra funds are allocated to the Russian National Guard whose forces are actively involved in supporting the Russian occupation regime in Ukraine.

Shortly after the planned budget was released, the Kremlin announced “partial mobilisation”. As a result, some 318,000 persons were drafted into the army, which will require an additional increase in defence spending, by at least 372 billion roubles ($6bn) to pay for their salaries and other expenses till the end of the year.

The 2023 budget was drafted by the government and submitted to the parliament before the presidential decree on mobilisation thus it would not be a surprise if the actual military expenditures for both 2022 and 2023 are higher than what was officially announced. In any case, even with these numbers, Russia’s military spending in 2022 will exceed 5 percent of GDP, which is unprecedented.

Still, the windfall earnings from oil and gas are compensating to a certain extent war-related spending. Thus, Russia will end this year with a deficit of 0.9 percent of GDP or about $15bn.

Because the external debt financing markets are closed for Russia after the introduction of the Western sanctions and the potential for domestic borrowing is limited, the deficit will be financed, mainly, from accumulated reserves, as Russian Prime Minister Mikhail Mishustin has announced.

In October, the fund held some 10.7 trillion roubles ($171bn); the liquid part of it, which can be used for such payments, amounted to 7.5 trillion roubles ($120bn) – more than enough to pay for the 2022 deficit.

A challenging 2023

In the 2023 budget, the government has put in a 6.5 percent increase in defence spending, which amounts to compensating for inflation. This assumes that war expenditure will not grow next year.

I have some doubts regarding this assumption. The expenses for the additional mobilised troops were not included in the 2022 budget, which, along with the possible delay in payments of compensation to the families of war casualties, will likely force the government to revise this number.

Moreover, defence minister Sergey Shoigu announced a 50 percent increase in military procurement for next year and he did so after the State Duma passed the 2023 budget. I do not see space for this in the budgetary figures.

Revenues, like spending, also cannot be easily foreseen for 2023. The windfall profits from hydrocarbons inspired some optimism in the Kremlin, which was reflected in the estimates the government put forward of economic growth resuming in the first quarter of next year.

Many experts do not share the government's optimism. Even the official forecast of the Bank of Russia suggests that Russian economic growth will resume in the second half of 2023.

A key unknown in next year's budget is also the revenue from hydrocarbons, specifically oil. The EU stopped imports of Russian crude oil on December 5 and will halt the purchase of Russian oil products on February 5. The Union, along with G7 and Australia, is also imposing a price cap of $60 on Russian oil.

As a result, it is unlikely that Russia will be able to increase oil exports next year to match pre-war levels. The average price of Russian export oil in 2021 was $69 per barrel. The current rouble-dollar exchange rate is 15 percent higher than the 2021 average, which is likely to continue into the new year. These factors may reduce 2023 budget revenues from hydrocarbon production and exports by 15 to 20 percent ($22bn to $29bn) of 2021 levels.

In response to the expected drop in revenues, the government has announced an increase in taxes on oil and gas companies as well as on metal and coal producers. These could bring in enough revenue to compensate for up to 75 percent of the revenue reduction.

Thus, the risk of not reaching the planned revenues in 2023 remains, but it will be limited to 5-6 percent of total budget revenues, according to my estimates.

Enough money for the war, unfortunately

Although the budget is planned under high uncertainty, it cannot be called unstable. Under different circumstances, its revenues may turn out above or below the planned level. Still, the scale of this deviation, according to my assessment, does not exceed 1 percent of GDP ($17.2bn) in either direction.

Consequently, even if revenues are lower, the budget deficit would not exceed 3 percent of GDP ($52bn), which can be entirely financed from reserves (currently at $120bn).

At the same time, there seems to be no opportunity or desire on the part of Western countries to intensify sanctions pressure on Russia. This means the Russian budget would not face any sanctions-related shocks in 2023.

With all of this in mind, I do not foresee any major financial constraints that could force the Kremlin to radically change its aggressive policy towards Ukraine.

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