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The Russian Economy at a Turning Point

As the War Boom Ends, the Kremlin Faces Growing Economic Risks

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Russia plans to significantly step up its military spending once again in 2025. Both the production of weapons and the recruitment of soldiers are becoming increasingly expensive. Over the past two years, strong government demand has triggered a war boom in parts of the Russian economy. Incomes have risen and there is new optimism about the economy. However, owing to labour shortages and the impact of Western sanctions, economic growth has stalled this year, while inflation has remained stubbornly elevated. The Central Bank is using very high interest rates to fight price increases, which is creating more headwinds for the economy but has so far failed to slow inflation. Amid the deteriorating outlook for the Russian economy in 2025, the country is more vulnerable to economic crises. New sanctions or a drop in oil prices could trigger a recession.

On 21 November 2024, the Russian State Duma adopted the federal budget for next year. Military spending is set to increase significantly: the defence budget will rise by one quarter to 13.5 trillion rubles, which, at the current exchange rate, is equivalent to 130 billion euros. Given that Russia is waging a war against Ukraine, this sum might seem rather small. However, the purchasing power of military spending in Russia must be taken into account. Translated into German prices, Russia's defence budget amounts to some 350 billion euros.

Russia's total military spending will be somewhere between 7 per cent and 8 per cent of gross domestic product (GDP), similar to the 2024 level, which was a record in Russian post-Soviet history. In 2021, the year before Russia's full-scale invasion of Ukraine, military spending was just 3.6 per cent of GDP. How much of Russian budgetary expenditures do, in fact, go towards the war is very difficult to assess. Spending not directly related to the military, such as healthcare and construction in the illegally annexed Ukrainian territories, inflates the overall bill.

At the start of the full-scale invasion in 2022, Russia was able to finance the additional expenditures through revenues from the historic boom in its energy exports. Since 2023, energy revenues have declined amid falling prices on global commodity markets and with sanctions cutting into Russian export revenues. As a result, Russia has recently been running budget deficits, but at around 2 per cent of GDP, they do not threaten economic stability. Fiscal short-

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falls of this magnitude can be covered by the National Welfare Fund and domestic borrowing for several years.

Starting in 2025, some taxes will be hiked so that the budget can return to structural balance, despite increased military spending: high-income earners will face higher income taxes and corporations higher profit taxes. Revenues will also be raised through much higher fees on imports of cars and lorries. At the same time, social expenditures are declining, not because of cuts in welfare but because the number of pensioners is falling — the official retirement age is gradually being raised and Russia suffered a very high Covid death toll, especially among the elderly. However, it is doubtful whether Russia's budget deficit will, in fact, shrink according to plan: since 2022, spending has been significantly higher than planned each year.

War boom nears an end

The significant increase in demand for weapons and other goods needed at the front in Ukraine has triggered a strong economic upturn in many Russian regions. Industrial production has grown significantly compared with 2021, the expansion having been almost exclusively driven by sectors that are related to the military-industrial complex. There are no official statistics on Russian arms manufacture. Instead, the output is added to categories such as "Other Metal Goods", the production of which has almost tripled since 2021.

The key production lines in Russia's arms industry are now running 24 hours a day, which explains most of the increase in the manufacture of weapons. According to Russian First Deputy Prime Minister Denis Manturov, Russia's arms industry added 520,000 new workers in 2023 and was looking to add another 160,000 this year.

Throughout 2024, Russian weapons production has increased more slowly than during the previous two years. The main reason is probably the lack of specialized personnel. Also, the construction of new factories takes time and that process has been at least slowed down by Western sanctions, as specialized machinery can no longer be imported so readily.

Despite the increase in arms production, Russia continues to struggle to make up for the material losses it suffers at the front. Moscow has to rely on imports from countries such as Iran or North Korea (see SWP Comment 49/2024). In the case of some weapons systems, the industry is able to deliver in large quantities only because it is tapping into the stocks of vehicles that were built up during the Soviet era. Only about 20 per cent of new armoured vehicles are built from scratch. This means that much of the cost of Russia's current war against Ukraine today has, in fact, been met by the state expenditures of the Soviet Union.

Meanwhile, the recruitment of soldiers has slowed somewhat, too, according to official figures, and has become much more expensive. According to the Russian Defence Ministry, 540,000 recruits were added in 2023, while Dmitry Medvedev, the deputy chairman of Russia's Security Council, announced that another 190,000 signed up during the period January-July 2024. It is very difficult to verify these figures, but they are generally supported by indicators such as Russian budget spending on recruitment.

With the exception of the partial mobilization campaign in autumn 2022, the Russian government has sought to find Russian men willing to sign a voluntary contract with the Defence Ministry. Many are lured by enormous cash payments, but in some cases pressure and coercion play a role (see SWP Comment 24/2024). So far, the Kremlin has been able to find enough recruits to replace — at least quantitatively — those lost at the front.

Signing bonuses for military newcomers have increased significantly in most regions of Russia in 2024, which can be interpreted as a sign of growing difficulties in recruiting. For example, recruits in Nizhny Novgorod are paid a regional bonus of 2.6 million rubles (25,000 euros or 68,000 euros if the higher purchasing power in Russia is taken into account); this is many times more than the average monthly salary of 66,000 rubles. At the beginning of 2024, the regional signing bonus for new recruits stood at just 50,000 rubles, before rising to 500,000 rubles in March and 1 million rubles in April.

Overheating economy

The enormous war expenditures have led to a sharp increase in aggregate demand. Russian Finance Minister Anton Siluanov estimates that the fiscal impulse for the period 2022—24 totalled 10 per cent of Russia's annual GDP. The result has been high GDP growth rates: in 2023, the Russian economy grew 3.6 per cent, largely owing to the creation of 2 million new jobs, most of which were in the defence industry and the army.

However, this growth model has reached its limits. Unemployment is at a historical low of 2.3 per cent and there is an acute labour shortage. The Russian Central Bank still expects the economy to grow around 3.5—4 per cent this year; but most of that growth will be due to the statistical base effect (meaning that last year's dynamics are reflected, not the current situation). In fact, the Russian economy has barely grown since early 2024. And in September of this year, leading indicators such as the S&P Purchasing Managers' Index were already signalling a contraction in Russian manufacturing — for the first time since 2022.

Russia's labour shortage is exacerbated by demographic trends. Each year, the population in the 20-65 age group shrinks by about 1 million people. The impact of this development on the labour markets can be only partly offset by the gradual increase of the retirement age. In addition, labour migration to Russia has fallen to its lowest level in 10 years owing to an increasingly hostile environment, harassment and even occupational bans for migrants in Russia, among other reasons.

For most employees in Russia, the labour shortage has been good news — at least initially — as it has led to rapidly increasing wages. In 2024 alone, the average wage grew by 19 per cent over the previous year. In the Russian military-industrial complex, the pay hikes have been even bigger. For example, Russia's largest tank manufacturer, Uralvagonzavod, increased wages by 12 per cent in May 2024 and then again by 28 per cent in August.

The higher wages have led to optimism about the economy among the Russian population. Consumer spending is on the rise. But prices are rising, too: in October 2024, seasonally adjusted core inflation was 9.7 per cent annualized. Western sanctions are partly responsible for inflation, as they make imports more expensive by complicating international logistics and payments for Russian businesses. At the same time, Russian export revenues from oil, coal and other commodities have decreased under the sanctions; as a result, the ruble has weakened, which means higher import prices.

To bring inflation under control, the Russian Central Bank incrementally raised the key interest rate from 7.5 per cent in July 2023 to 21 per cent in November 2024. Short-term interest rates are at their highest level in 25 years. This creates stronger headwinds for the Russian economy because companies' interest costs rise and demand fall. The construction sector has been particularly hard hit: mortgage rates have risen to more than 30 per cent. At the same time, government subsidies for mortgages were cut in the summer.

Despite the slowing economy, inflation has not yet cooled off. The Central Bank is considering further rate hikes. In the meantime, there is a growing discussion in Russia about a possible stagflation scenario (that is, high inflation and economic stagnation).

A clouded outlook

As a result of the slowing Russian economy, the surge in incomes is likely over for the time being, although unemployment will not rise significantly as long as the labour shortage persists. After three years of wage hikes, average Russians are unlikely to suffer much during a period of economic stagnation, even if rising food prices fuel discontent. High interest rates are expected to lead to a wave of bankruptcies. And the situation will become particularly difficult for heavily indebted Russian households.

At the same time, Russia's fiscal balance is likely to be significantly worse than planned. Estimates for tax revenues in 2025 are very optimistic, as they are based on forecasts made in the summer, when 2.5 per cent growth was still expected — the Central Bank is now predicting just 0.5—1.5 per cent. Furthermore, high interest rates translate into higher budget expenditures, as the interest on a large part of the Russian public debt is paid at a floating rate. The Finance Ministry's most likely response to all these problems will be to cut non-military expenditures and delay investment spending.

While the economic difficulties are likely to dampen optimism among the population and force the government to make political trade-offs, Russia's ability to fight the war in Ukraine will not be directly affected. More important in this respect is the success of recruitment campaigns and the capacity of the Russian military-industrial complex. The future of Russian arms production hinges on the remaining stocks of Soviet-era armoured vehicles. Depending on the weapons system, these stocks have shrunk considerably; and in some cases, maintaining production volumes could become more difficult as soon as in 2025. To continue fighting Ukraine at the same level of intensity, Russia would have to significantly increase the capacity of its arms industry.

The extent to which the economic slowdown becomes a problem for Russia also depends on the price of oil next year. A sustained decline in export revenues would lead to a rapid deterioration in the economic outlook. The Central Bank would be unable to intervene effectively because most of its reserves are frozen under Western sanctions. The devaluation of the ruble, high inflation and recession would all be inevitable.

Moreover, the slowing economy makes Russia more vulnerable to further sanctions. As the world oil market is relatively well supplied at present, this could be the time to tighten sanctions on Russian oil exports. New sanctions could also target other key Russian exports, such as liquefied natural gas and fertilizers. Furthermore, Russia's military-industrial complex remains highly dependent on Western dual-use goods and machinery; and Moscow continues to purchase large quantities of Western components for weapons production through third countries — above all, China. Pressure on these countries and the companies involved should be increased, both through diplomatic channels and through new sanctions.

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