Russia and Eurasia Studies programme

Russia's wartime economy

Neither boom nor bust

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> Of course, national defence is the top priority, but in resolving strategic tasks in this area, we should not repeat the mistakes of the past and should not destroy our own economy.
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> ***Vladimir Putin,*** *President of the Russian Federation, address to the Federal Assembly, 21 February 2023*

Are the sanctions working and will economic factors constrain Russia's ability to continue its war against Ukraine? There are no simple answers to these questions. In fact, economists have provided wildly differing predictions of the prospects for Russia's economy. In February 2023, the Yale economist, Jeffrey Sonnenfeld, assessed that Russia's economy was "self-immolating," while the International Monetary Fund predicted Russian GDP growth in 2023 of 1.5%, which would already put the Russian economy on track to recover from last year's recession by 2024. Who is right? Is Russia's economy experiencing a boom, or bust? Our analysis in the FOI report, *Russia's War Against Ukraine and the West: The First Year*, concludes that it is a matter of perspective. A boom in military spending supports economic growth in the short term, but creates more than one risk of an economic "hangover" in the future. The quote by president Putin alludes to the 1980s, when it became apparent that the Soviet Union's high military expenditure was unsustainable. Russia faces a similar dilemma today.

Effects of the war and sanctions

Assessing Russia's economy has become more difficult since the invasion. There has been an increasing "fog of economic war," with Russia abstaining from publishing some economic indicators, notably data on trade and budget expenditure. There is also discussion of the reliability of the data that is still being published, especially Russian gross domestic product (GDP) figures and inflation statistics. However, the analysis in our FOI report cautions against completely dismissing the official Russian economic data. What data is still being published seems largely consistent with other statistics and observations.

One way to analyse the changes is to consider the immediate, short- and long-term effects. In the first weeks after the invasion, there was a period of turbulence, with high inflation, a rapidly weakening rouble, a sharp drop in imports, and fears of a financial crisis, as people and companies started withdrawing money from their accounts. The Russian government was successful, however, in stabilising the economic situation in the weeks that followed, thus avoiding an economic crisis. Since the Western sanctions against Russian energy exports only became effective at the end of 2022 and the beginning of 2023, Russia could continue its export of oil and gas until then and thereby replenish its financial reserves. During the first half of 2023, revenue from energy exports fell, but economic indicators, such as the rate of inflation, retail sales and industrial production, continued to improve.

While the immediate and short-term economic impacts of the sanctions were modest, they had another important effect, with long-term consequences: they forced Russia into a more dependent trading relationship with its eastern trading partners, especially China and India. The dependence is twofold: Russia needs to sell its oil, and it needs to import technological and other goods that are no longer exported directly to Russia by Western countries. Structural changes in Russian trade relations have thus taken place.

So far, the sanctions have not constrained Russia's ability to finance its war against Ukraine. Russia's government and businesses have been adapting to the sanctions, diminishing their effects. However, it is evident that the sanctions, coupled with the effects of the war, have induced observable changes in Russian society and economy. The combined effects of the war and the sanctions are accumulating over time, and have created

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trade-offs for the Russian government. The government has been forced to use its financial reserves and reduce spending on other things, in order to finance military expenditure.

Military expenditure

During 2022, the government kept military expenditure at around 4.4% of GDP, which is a level in line with Russia's military burden during the last decade. The Russian government's reluctance to increase military spending during the first year of full-scale war could be connected to its policy of keeping up the appearance that the "special military operation" is limited in scope and will not affect the majority of the Russian population. This consideration might be important for the government, not least in the run-up to Russian presidential elections in March 2024. The government has historically been careful to preserve Russia's macroeconomic stability and avoid an excessively large federal budget deficit.

Nevertheless, given the lack of Russian military progress in Ukraine, in 2023 the government has chosen to gradually increase military spending. According to an estimate by economist Janis Kluge, the government has already spent around 80% of its national defence budget during the first half of 2023. The government is now spending more money on soldiers' salaries, social payments to veterans and the families of killed soldiers, construction of fortifications and other military infrastructure, as well as on producing more tanks, guns, ammunition, uniforms and other materiel for the Russian Armed Forces.

This spending lies behind the current burst of growth in the Russian economy. The increased government expenditure raises GDP and stimulates the economy, contributing to a greater demand for labour and of imports to support the higher economic activity. In this sense, there is a short-term economic "boom" related to military expenditure, which can be observed in GDP data and industrial production statistics. Working-class Russians have to a certain degree benefitted from this change, seeing their salaries rise as employers seek to attract more labour to their factories and businesses.

Growing imbalances

Increased military expenditure can stimulate the Russian economy, but there are important downsides, both in the short and the long run. In the short run, imbalances are created, as Russia's defence industry demands increased amounts of labour and imports of inputs. The increase in imports, combined with falling export revenues caused by the sanctions, leads to a current account deficit, which weakens the rouble and in turn leads to the risk of increased inflation. The Russian Central Bank has already started increasing its interest rate in order to curb the inflation, but a high interest rate will damage economic growth.

In the long run, a high rate of military spending is good for neither the economy's growth potential nor the civilian economy. By choosing to pursue an offensive war, the government has foregone the option to invest in its own country and population, on health, education, research and infrastructure. The war also worsens Russia's long-standing negative demographic trend. In addition, the longer the war continues, the more the economy becomes locked into a dependence on high military expenditures. When, or if, the government decides to decrease military spending, there will be the risk of an economic "hangover," caused by a reduction in orders for the defence industry, slower construction of military infrastructure and a lower number of contract soldiers with salaries.

Russia's dilemma is that the more its government spends in the short term on trying to achieve victory in Ukraine, the smaller its economy risks becoming in the longer run in comparison to the West and other countries that Russia would like to see as peers, such as China and India.

To conclude, Russia's economy is neither booming, nor bust. The government is prioritising military expenditures over investments in its own economy and population, so postponing its economic challenges. For the moment, it can afford to do so. In the end, what really matters is the duration and intensity of the war. The longer Russia decides to continue its war against Ukraine, the more destruction it will cause to both its own and Ukraine's economies and populations. ■

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This brief is based on the chapter, *"Russia's economy: bracing for the long haul,"* for the FOI report, *Russia's War Against Ukraine and the West: The First Year* The entire report may be obtained from *www.foi.se* or via the following QR code: