Russia's economy 2025—
Trends, challenges, and dilemmas

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Cover: The façade of the building that houses the Central Bank of the Russian Federation. Photo: Yuri Kochetkov (EPA/TT).

Sammanfattning

Ryssland kan fortsätta finansiera nuvarande nivå av militärutgifter och måttligt stora budgetunderskott i minst två–tre år till genom att tömma Nationella välfärdsfonden, höja skatterna och låna mer pengar. En sådan politik skulle leda till ytterligare inflation och lägre tillväxt. Den skulle också öka risken för en bankkris eller lokala ekonomiska kriser i regionerna. Det finns dock inte mycket som talar för att utmaningarna för närvarande är så allvarliga att de riskerar att skapa en ekonomisk kris som regeringen inte kan hantera. Problemet för den ryska ledningen är snarare att det finns en oförutsägbar och icke kvantifierbar risk för att den kommer att behöva påtvinga befolkningen ekonomiska uppoffringar som kan få svåröverblickbara konsekvenser. Dessutom gör de höga militärutgifterna att Rysslands ekonomi på sikt ytterligare försvagas jämfört med Europas, USA:s och Kinas ekonomier.

Nyckelord: Ryssland, ekonomi, militärutgifter

Summary

Russia can continue to finance the current level of military expenditure and moderately large budget deficits for at least another two to three years by emptying its National Wealth Fund, raising taxes and borrowing more money. Such a policy would lead to additional inflationary pressure and lower growth. It would also increase the risk of a crisis in the banking sector or localised economic crises in the regions. However, there are no strong reasons to believe that the current economic challenges are so severe that the government cannot manage them. The problem for the Russian leadership is, rather, that there is an unpredictable and unquantifiable risk that it will have to impose economic hardships upon its population and firms, which in turn could lead to uncertain consequences. In addition, the high level of military expenditures means that, in the longer run, Russia's economy is weakening in relation to the economies of Europe, the United States, and China.

Keywords: Russia, economy, military expenditure

Foreword

I would like to express my special thanks to Maria Perrotta Berlin at the Stockholm Institute of Transition Economics (Stockholm School of Economics) for reviewing an earlier draft of this text. I would also like to thank Malek Finn Khan, Karolina Gasinska Singh, Maria Engqvist, Carolina Vendil Pallin, Emma-Lina Löflund, Cecilie Sendstad, Julie Udal Helseth, Richard Langlais, and Karin Blext for their valuable comments and support in the writing and formatting of the report. This text is a translation by Richard Langlais of a Swedish version of the report which was published in April 2025.

Emil Wannheden, Analyst

Stockholm, 13 May 2025

Contents

Introduction

Informed analysts and observers largely agree on the overarching challenges facing the Russian economy. However, there is some disagreement over how serious these challenges are, whether they represent immediate problems, and to what extent the statistics published by the Russian Federal State Statistics Service (Rosstat) can be considered reliable. It is not particularly surprising that assessments have diverged, given the difficulties of interpreting Russian statistics.

This report examines the state of the Russian economy at the beginning of 2025 and addresses three questions: What is the current trajectory of economic developments? What are the main short-term challenges? And finally, what are the economic dilemmas that the Russian leadership is facing?

I have chosen to focus on the short-term challenges, as these are the issues most likely to influence the Russian leadership and its policymaking in 2025. The analysis is based on a critical reading of official Russian statistics, reporting from the Central Bank of the Russian Federation (hereafter the Central Bank), economic coverage in Russian media, and assessments by research institutes and analysts both within and outside Russia. A limitation of this approach is that it makes it difficult to assess the reliability of the data. I have sought to reduce this uncertainty by comparing and discussing multiple sources. In most cases, even the official statistics point to major economic challenges. The overall picture exhibits internal coherence, indicating that the conclusions have external validity.

The text is divided into four sections. The first discusses how Russian economic statistics should be interpreted in light of the changes the country has undergone over the past three years. The second analyses the Russian economy on the basis of the most important statistical indicators published by Russian authorities. The third identifies the main short-term challenges facing the Russian economy. The fourth presents the conclusions and outlines the strategic economic dilemmas confronting the Russian leadership.

1 Interpreting Russia’s economic statistics

Any current assessment of the Russian economy based on open sources is complicated by the fact that many economic indicators are no longer published. These include statistics on Russia’s foreign trade, most indicators related to the financial sector, and detailed data on government budget expenditures. In addition, since June 2023 companies have no longer been required to publish annual reports or even basic information about ownership structures or their boards of directors.

Representatives of the Russian government have regularly highlighted selected economic indicators to demonstrate that the economy is performing well. President Putin, for instance, frequently refers to GDP (gross domestic product) growth and low unemployment. This communication should be viewed as part of the information war that Russia is waging against the West, with the aim of undermining unity around sanctions and support for Ukraine. The Russian government is also seeking to persuade its own population that the economy is doing well, including through selective reporting in the Russian mass media.

At the same time, discussion among economists, analysts, and business leaders within Russia regarding the problems in the economy is relatively open, even though the war is never cited as a cause of these problems. The Central Bank regularly publishes detailed reports on various aspects of the economy and is transparent in its communications about the fact that many of the prevailing challenges have been caused by sanctions. The Bank sees this transparency as necessary in order to justify its strict interest-rate policy. Another example of how economic developments are analysed in an open and forthright manner can be found in the reports from the state-affiliated economic think tank TsMAKP (*Tsentr Makroekonomicheskogo analiza i kratkosrochnogo prognozirovaniia*, the Centre for Macroeconomic Analysis and Short-Term Forecasting), whose director, Dmitry Belousov, is the brother of Defence Minister Andrei Belousov. TsMAKP continuously assesses risks to economic stability and has criticised the Central Bank’s strict interest rate policy, which it argues is counterproductive.[1]

The Russian leadership faces a dilemma: on the one hand, it must provide economic statistics in order for the Central Bank, government agencies, and businesses to function effectively; on the other hand, it has an incentive to withhold or manipulate statistics to make the economy appear stronger than it actually is. The report *The Russian Economy in the Fog of War*, published last year by the Stockholm Institute of Transition Economics at the Stockholm School of

[1] Tsentr Makroekonomicheskogo analiza i kratkosrochnogo prognozirovaniia, *O vlijanii izmeneniia kljuchevoi stavki na promyshlennuiu inflatsiiu i veroiatnost korporativnykh bankrotsv*, 8 December 2024. http://www.forecast.ru/_ARCHIVE/Presentations/Salnikov/20241209_stavka.pdf.

Economics, emphasised that inflation figures — and thus real GDP growth (which is adjusted for inflation) — are particularly vulnerable to manipulation.[2] Whether the inflation figures have in fact been manipulated is difficult to determine, but there is reason for suspicion. For example, Rosstat has revised the method used to calculate the consumer price index four times since March 2022.[3] Food accounts for approximately one-third of the current consumer price index, but many Russian families spend a significantly larger share of their income on food and therefore experience a higher rate of inflation, as food is the category of goods whose prices have risen the fastest.

According to an analysis by the Bank of Finland Institute for Emerging Economies (BOFIT), it cannot be ruled out that Rosstat manipulates all statistics in a way that ensures internal consistency. However, there is also no strong reason to believe that this is the case. Certain indicators have become more volatile, which could be a sign of manipulation. At the same time, the volatility may also be explained by factors related to changes brought about by the war.[4] Rosstat frequently updates its methods for calculating indicators but rarely explains how they have changed. Still, it remains worthwhile to study Russia's official economic statistics. Most indicators likely reflect reality to some extent. We know, for example, that there is no hyperinflation in Russia, even if inflation is likely somewhat higher than the official figure.

If the official inflation figures are underestimated, this means that official real GDP growth is overestimated. However, there are also other sound reasons why Russia's current GDP growth should be interpreted differently from before the war, and not be seen as a measure of the health of the economy or the wellbeing of the population. First, GDP has increased (or not declined) primarily due to a sharp rise in public spending related to the war in Ukraine. Increased spending on military materiel, such as refurbished tanks, or on soldiers' wages, contributes to short-term GDP growth but is not beneficial for long-term economic development. In practice, this spending contributes mostly to inflation and only marginally to economic progress. Second, Western sanctions have altered Russia's trade patterns with the rest of the world. Many imported goods and intermediate inputs are no longer of the same quality as before the war, which reduces comparability.

A more fundamental observation is that the war, sanctions, and government policy have gradually changed the structure of the Russian economy. The basic features remain: a limited market economy with strong state presence, weak protection of

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[2] Stockholm Institute of Transition Economics, *The Russian Economy in the Fog of War* (Stockholm: Konjunkturinstitutet, 2024).

[3] Oleksii Plastun och Anna Vorontsova, *Illusion of Stability: Never trust Russian stats.* 25 December 2024. https://voxukraine.org/en/illusion-of-stability-never-trust-russian-stats.

[4] Heli Simola, *Detecting irregularities in Russian economic statistics,* BOFIT Policy Brief (Helsinki: Bank of Finland, 2024).

property rights, a high level of corruption, and dependence on resource- and energy-related exports. The change lies in the fact that certain aspects have become more pronounced. State involvement in the economy is increasing, the rule of law is weakening, and militarisation is accelerating. Trade is now directed mainly eastward, rather than westward. The war has caused a significant labour shortage, and immigration is declining. The sanctions have led to a greater degree of domestic consumption, as people are purchasing more goods and services inside Russia rather than abroad, which has increased domestic demand.

Despite the sanctions, Russia is not a closed system, and its economy remains dependent on the outside world — primarily China — for both exports and imports. It is also important to note that although the state intervenes in the economy with increasing frequency, Russia is not a planned economy. There is no institution comparable to the Soviet Union’s State Planning Committee (Gosplan) and its five-year plans. In most parts of the economy, functioning price mechanisms still regulate supply and demand.

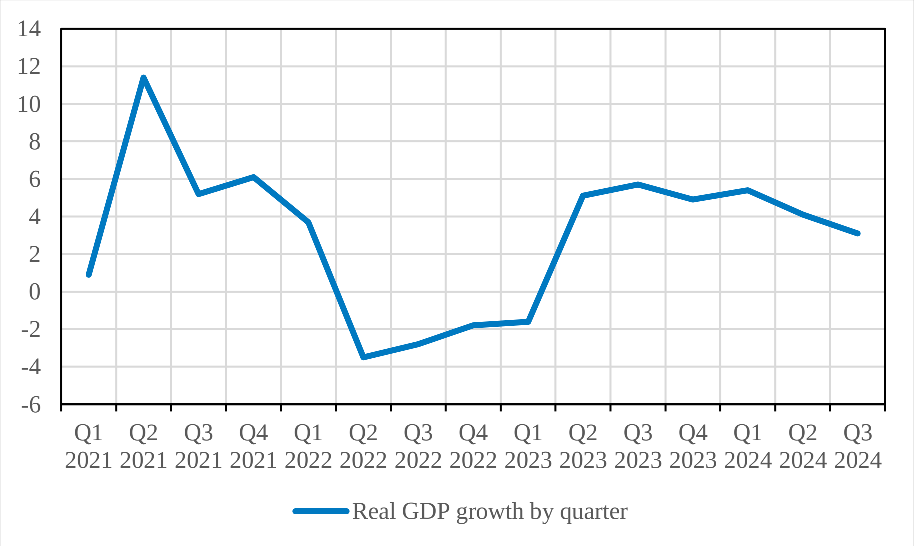
An important exception is the defence industry, where prices in domestic contracts are set by the state. This in itself is not unique to Russia, but the Russian defence industry has become so large that it occupies a special position within the economy. It is in this sector that wages are rising fastest, and it is the defence industry that is prioritised in the allocation of state resources (see the next section). A growing number of employees and subcontractors depend on the government contracts awarded to the large defence companies. This cascade effect means that certain towns and regions have also become heavily reliant on state defence contracts and on favourable loans to defence firms. In Russia, discussions are already underway on how the economy might manage a transition to peacetime. This would require, to some extent, that defence companies shift to civilian production — without being outcompeted by, for example, Chinese firms. This challenge recalls, in part, the situation of the early 1990s, when Russia had to deal with the legacy of the militarised Soviet economy.

Taken together, these changes mean that comparisons between the Russian economy and its pre-war state — or with other economies that are at peace — should be made with great caution.

2 Current situation according to official statistics

Russia's real GDP declined by 3.5 per cent year-on-year in the second quarter of 2022, coinciding with the economic uncertainty that arose following the country's invasion of Ukraine.[5] Since then, real GDP has recovered (Figure 1). The highest growth was recorded in the third quarter of 2023 (5.7 per cent), followed by a gradual slowdown in the growth rate. GDP growth can be attributed to a sharp increase in public spending and favourable lending to businesses and individuals, which has stimulated demand. However, the declining growth trend indicates that the economy no longer has the capacity to absorb this stimulus.

Figure 1: Growth of real GDP by quarter (year-on-year), per cent.



Source: Rosstat.

Inflation rose sharply in the first months following the invasion, with the consumer price index reaching 18 per cent year-on-year in May 2022 (Figure 2).[6] The Central Bank temporarily raised the key policy interest rate to 20 per cent in an effort to bring prices down, which initially succeeded. Inflation reached its lowest

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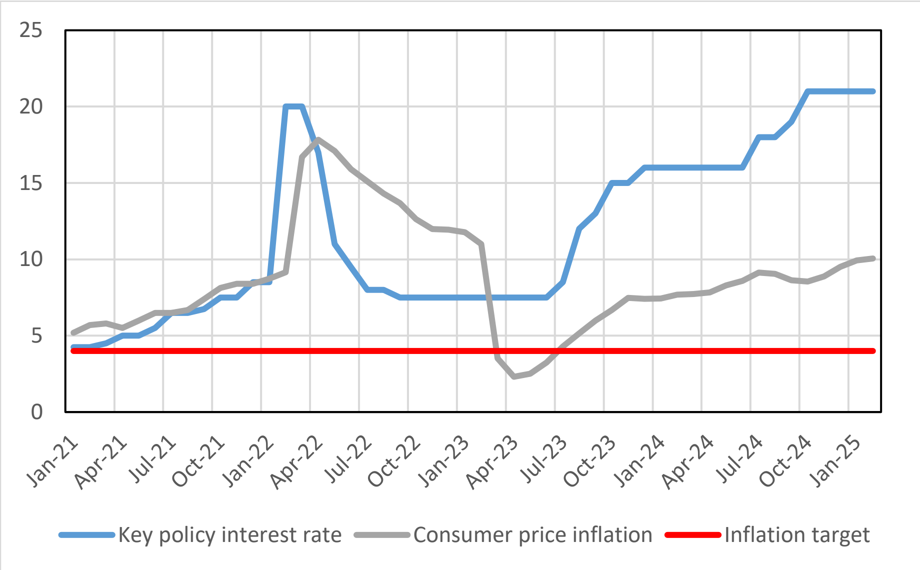
[5] Rosstat, *Statistika*, https://rosstat.gov.ru/statistics (accessed 2025-03-18).

[6] Rosstat, *Statistika*.

point in May 2023, at 2.5 per cent. The fact that inflation was not higher during this phase can be explained by the delayed impact of many of the war's and the sanctions' negative economic effects. Since April 2023, inflation has been rising steadily, despite the Central Bank gradually raising the interest rate to 21 per cent. More detailed statistics from Rosstat show that inflation is particularly high for food products. Despite continued inflationary pressure, the Central Bank chose not to raise the key policy interest rate further in December 2024, but in its communication has signalled that a continued tight monetary policy is necessary to bring prices down.

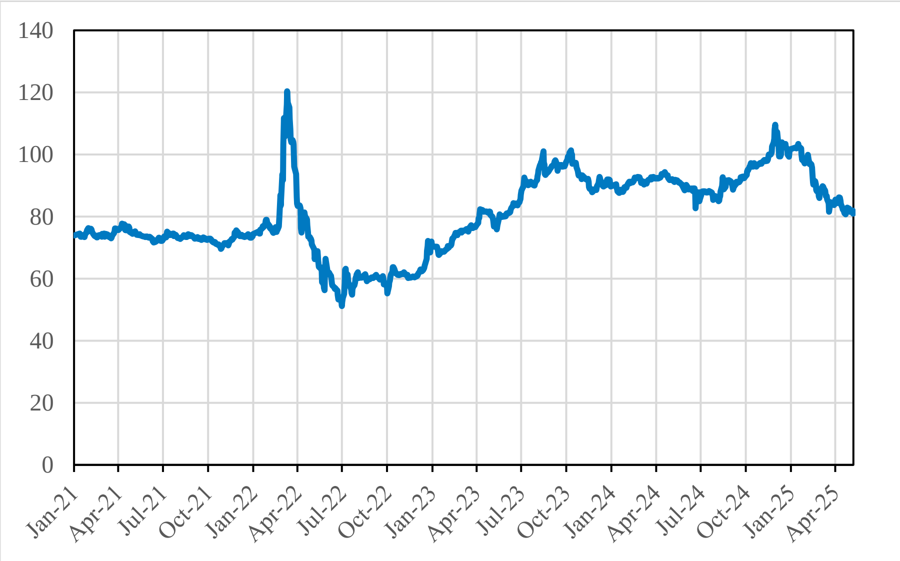
Figure 2: Consumer price index (monthly, seasonally adjusted), along with the key policy interest rate and inflation target, year-on-year, per cent.



Source: Central Bank of the Russian Federation.

The rouble's exchange rate against the US dollar has followed a similar trajectory. The rouble weakened in the first months following the invasion but subsequently strengthened due to high oil revenues, a high key policy interest rate, and restrictions on the outflow of foreign currency from Russia (Figure 3).[7] In June 2024, the United States (US) imposed sanctions on trading US dollars on the Moscow Exchange. Since then, the Central Bank's official rouble-to-dollar exchange rate has been based on reports from transactions between commercial banks. As a result, the official exchange rate is now more difficult to verify. According to the official rate, the rouble has strengthened in early 2025, after being weak throughout 2023 and 2024. A stronger rouble reduces export revenues and, consequently, tax revenues for the state budget, but it can help curb inflation by making imports cheaper.

Figure 3: Exchange rate, rouble/US dollar.

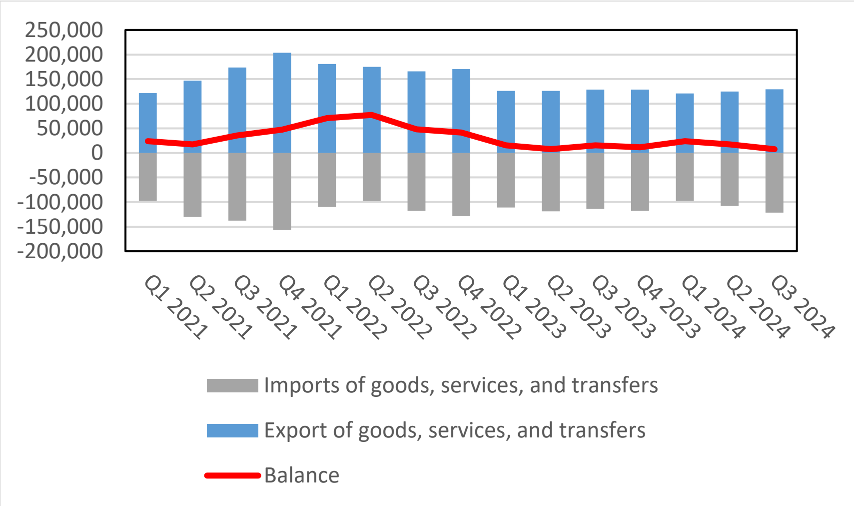


Source: Central Bank of the Russian Federation.

[7] Ibid.

Russia has maintained a positive current account balance over the past three years (Figure 4).[8] In 2022, the current account surplus rose sharply due to strong growth in energy exports, primarily oil and gas. Export revenues have since declined and remained stable since the first quarter of 2023. The level of imports has remained largely unchanged since the first quarter of 2022. As a result, the current account surplus increased significantly in 2022 before falling to a lower, but still positive, level. More detailed current account statistics show that substantial capital flight has taken place. Around USD 100 billion in direct and portfolio investments have left the country since 2022.

Figure 4: Current account balance by quarter, in billions of roubles.

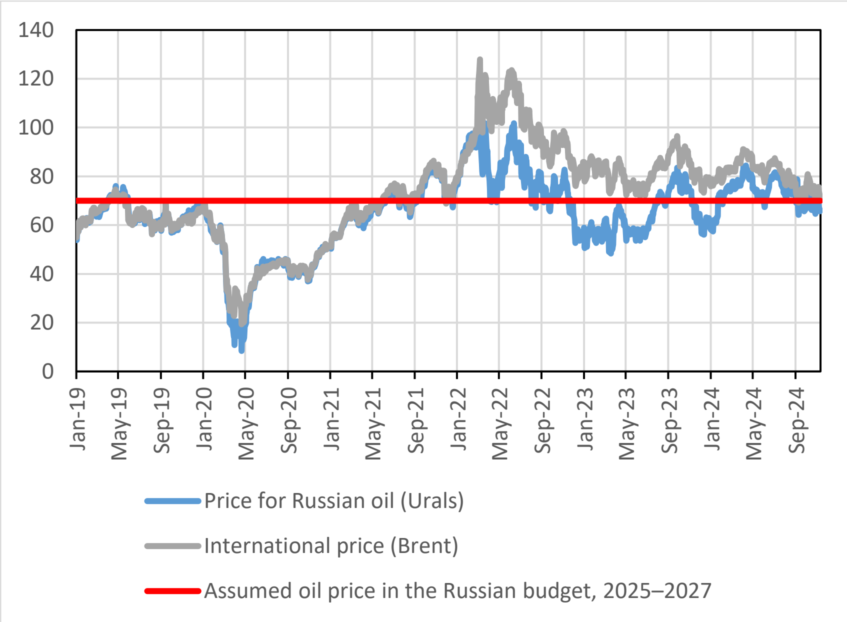


Source: Central Bank of the Russian Federation.

[8] Ibid.

The high level of energy exports, primarily oil, has supported the Russian economy since the invasion. Historically, the state budget has captured approximately 80 per cent of oil-related export revenues. Although these revenues have declined to some extent, they have not fallen as much as the energy-related sanctions were intended to achieve. The oil price cap, along with the US and EU embargoes on Russian oil, initially resulted in Russia receiving USD 20–30 less per barrel for its oil (Figure 5).[9] However, during 2024, this "discount" narrowed and amounted to only about USD 5 per barrel in December 2024.[10] New US sanctions targeting the Russian shadow fleet are likely to cause the discount on Russian oil to increase again. In the first months of 2025, the oil price has declined. On 21 April 2025, the Ministry of Economic Development lowered its forecast for the average 2025 price of Brent from 81.7 USD per barrel to 68.0 USD per barrel.

Figure 5: Global oil price (Brent) and Russian oil price (Urals), in USD per barrel.



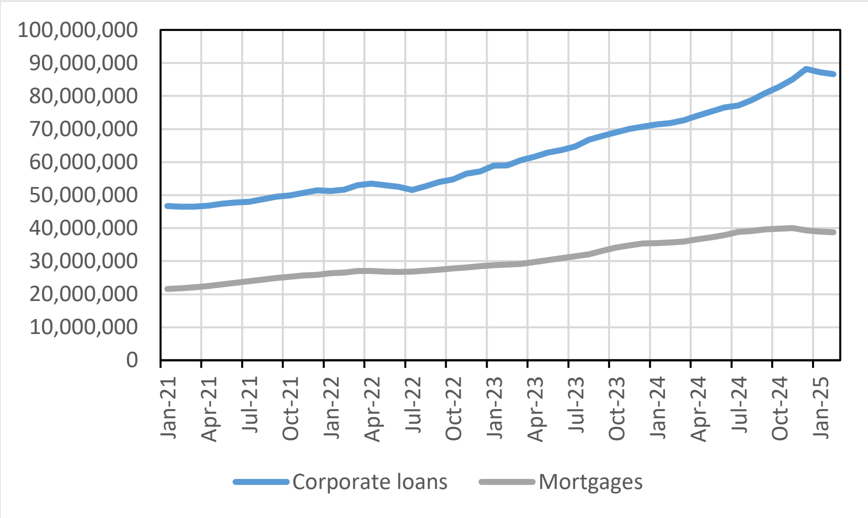
Source: Central Bank of the Russian Federation.

[9] Ibid.

[10] Daniel Spiro, Henrik Wachtmeister and Johan Gars, *Assessing the Impact of Oil Sanctions on Russia*, 25 December 2024. http://dx.doi.org/10.2139/ssrn.5071223

To stimulate the economy, the Russian government expanded its programme of state subsidies for corporate loans, mortgages, and consumer credit. This policy led to a 70 per cent increase in the volume of loans to businesses between the summer of 2022 and 2025 — an increase of approximately 3.7 trillion roubles (approximately USD 370 billion; see Figure 6).[11] Of these loans, around 9 per cent, or approximately 330 billion roubles (USD 33 billion), went to the defence-related industry.[12] In July 2024, the mortgage support programme was terminated, which has caused the growth in mortgage lending to level off. Data from December 2024 also show that the volume of business loans has begun to decline.

Figure 6: Business loans and mortgages in current prices, in millions of roubles.



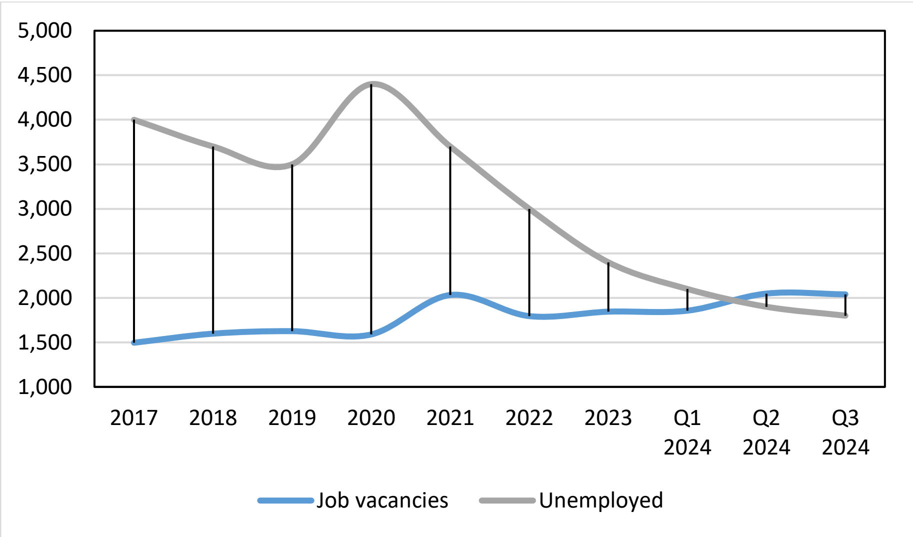
Source: Central Bank of the Russian Federation.

[11] Rosstat, *Statistika*.

[12] Iikka Korhonen, Sinikka Parviainen, Heli Simola and Laura Solanko, *How have three years of war changed the Russian economy?* BOFIT Policy Brief (Helsinki: Bank of Finland, 2025).

Unemployment in Russia stood at 2.4 per cent in the third quarter of 2024, a historic low (Figure 7).[13] During this quarter, the number of job vacancies listed on the website of the Federal Labour Agency exceeded the number of registered unemployed for the first time since 1999. The labour shortage has led to wage increases that, in many cases, have offset inflation for employed workers. However, wages have risen at different rates across sectors and regions. Data from Rosstat show that wages have increased most rapidly in sectors linked to the defence industry (Figure 8), as well as in regions with a high concentration of defence-related industries.[14]

Figure 7: Unemployment and job vacancies, thousands.

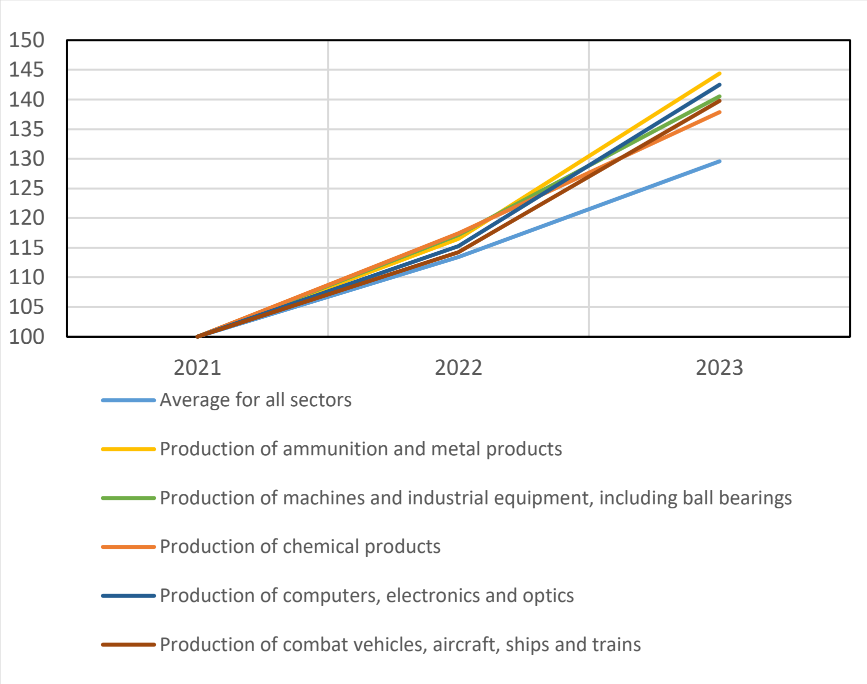


Source: Rosstat.

[13] Rosstat, *Statistika*.

[14] Ibid.

Figure 8: Average wage by sector in current prices, index (2021=100).



Source: Rosstat.

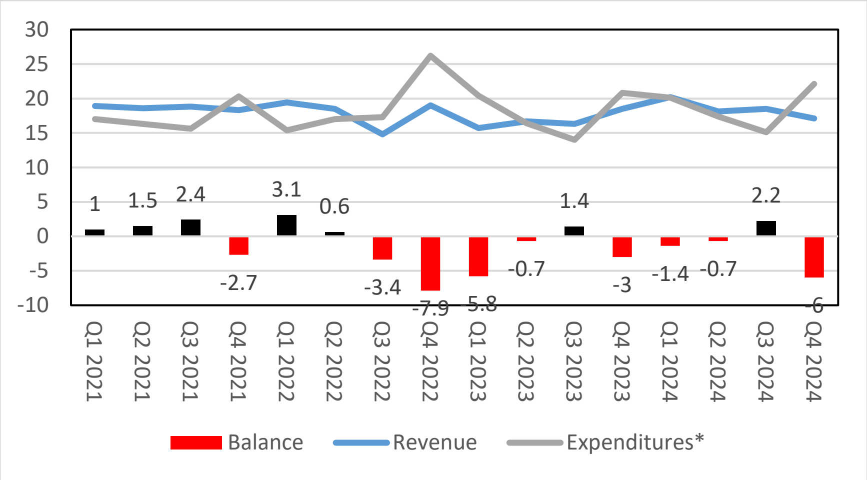
Over the past three years, the government's fiscal policy has focused on ensuring sufficient funding to continue the war against Ukraine, while at the same time, insofar as possible, maintaining economic stability and financing for social welfare. In navigating this balance, it has gradually become clear that the government has increasingly prioritised military spending, while budget discipline and welfare-related expenditures have been downgraded. Figure 9 shows the quarterly budget balance from 2021 to 2024. In most quarters, the budget has been in significant deficit.[15]

Russia's public debt remains relatively small compared to that of other countries. However, unlike many other states, Russia cannot raise funds on international capital markets, which means that the budget deficit must be financed domestically. So far, the Ministry of Finance has opted to cover the deficit primarily through a combination of issuing domestic government bonds and selling liquid assets from the National Wealth Fund. Both measures are inflationary, and the liquid assets in the National Wealth Fund are limited. Since 2022, these have declined from 8.432 trillion roubles in

[15] Ministry of Finance of Russia, *Statistika*, https://minfin.gov.ru/ru/statistics (accessed 2018-03-18).

January 2022 to around 3.8 trillion roubles in January 2025, equivalent to only about 2 per cent of GDP (in turn, barely one-third of the planned official defence budget for 2025).

Figure 9: Quarterly government revenue, expenditure, and budget balance, as a share of GDP.

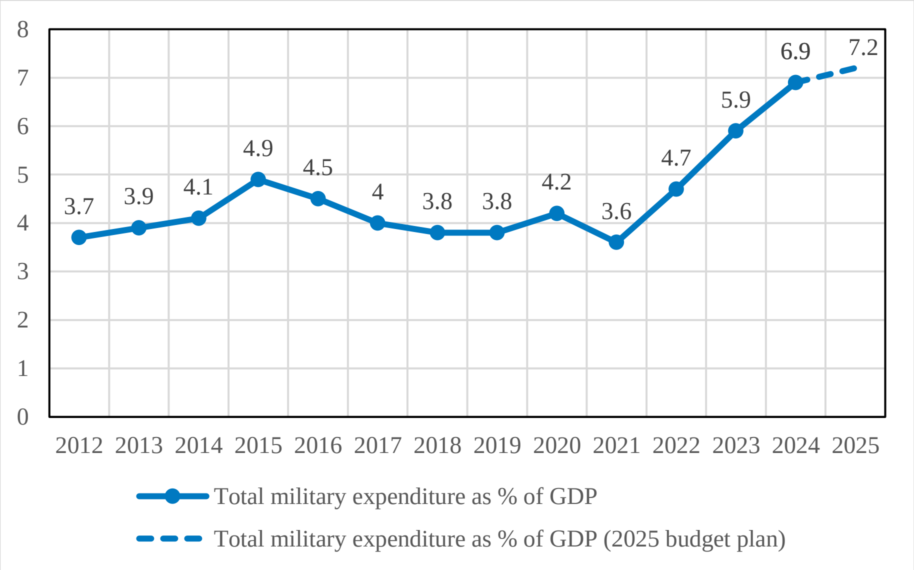


Source: Russian Ministry of Finance.

Note: *Expenditure does not include interest payments.

In 2022 and 2023, the government was able to maintain welfare-related spending while simultaneously increasing military expenditure. This was no longer possible in 2024. The economic effects of the war and sanctions, combined with steadily rising military spending, forced the government to raise income taxes and corporate taxes, while cutting welfare-related expenditure. The decline in energy-related exports has reduced the share of the budget financed by energy-related revenue to around 30 per cent for 2024. The government plans to reduce this share further in the coming years, in part by increasing several taxes and selling off confiscated Western companies and assets.[16]

Figure 10: Russia's total military expenditure since 2012, as a share of GDP.



Source: Stockholm International Peace Research Institute (SIPRI).

The official defence budget amounted to 5.8 per cent of GDP in 2024 and is planned to increase to 6.3 per cent in 2025. This is the highest figure since the dissolution of the Soviet Union and is twice as high as in 2021. However, the official defence budget is only a part of Russia's total military expenditure as defined by the Stockholm International Peace Research Institute (SIPRI). Figure 10 shows Russia's total military expenditure according to SIPRI's definition from

[16] Ivan Tkachev and Ekaterina Vinogradova, "Vlasti opredelili istochniki rosta dokhodov v biudzhete," *RBK*. 30 September 2024.

2012 to 2025.[17] The total military expenditure according to this definition in the 2025 budget amounts to 7.2 per cent of GDP. It is likely that actual expenditure will be even higher, since Russia has consistently overshot its military budgets the last three years. It should be noted that there are many war-related expenditures which are not included in this figure. According to a recent analysis by the Norwegian Defence Research Establishment (FFI), war-related expenditure in the 2025 budget amounts to at least 8.8 per cent of GDP.[18]

[17] Julian Cooper, *Another Budget for a Country at War: Military Expenditure in Russia's Federal Budget for 2024 and Beyond* (Stockholm: SIPRI, 2023); Julian Cooper, *Preparing for a fourth year of war: military spending in Russia's budget* (Stockholm: SIPRI, 2025); SIPRI, *Military Expenditure Database.* https://milex.sipri.org/sipri (accessed 2025-03-18).

[18] Cecilie Sendstad and Julie Udal Helseth, *Kremls økonomiske planer – den russiske regjeringens forslag til føderalt budsjett for 2025 og planperioden 2026–2027* (Oslo: Forsvarets Forskningsinstitutt, 2024).

3 Short-term challenges

Russia's economy faces both short- and long-term challenges. The short-term challenges are already evident and are likely to intensify in 2025 and 2026, while the long-term challenges will have a greater impact in three to five years and further into the future. These long-term challenges are therefore significant for Russia's long-term development, but they are unlikely to affect the immediate outcome of the war in Ukraine.[19]

In this section, I assume that Russia's political leadership will choose to maintain current high levels of military expenditure over the next two to three years. It is unlikely that the leadership will seek to reduce military spending in the short term, even if the war is paused, as it will be necessary to rebuild the Armed Forces and maintain a strong military presence in Ukraine. Sooner or later, the state will also need to finance the rollover of the large volume of loans extended to defence companies since 2022. In other words, there is already a form of "debt" created by military spending that will need to be repaid in the future.[20] I also assume that the current sanctions will remain in place. If sanctions were to be partially or fully lifted in connection with a ceasefire or peace agreement, the economic challenges would be less acute. A ceasefire could also benefit the economy in other ways—for example, fewer men would need to be recruited into the Armed Forces each month, which in turn would ease the labour shortage.

The main short-term economic challenges include financing the state budget, oil exports, inflation, the risk of a wave of business bankruptcies, threats to financial stability, capacity constraints linked to shortages of labour and capital, and regional-level challenges.

3.1 The State Budget

The combination of high military expenditure and declining export revenues makes it difficult to balance the budget. As noted above, any budget deficit must be financed with domestic resources: the sale of remaining reserves from the

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[19] These challenges are not addressed in this text, but they include at least the following issues: a highly negative demographic trend; degradation of human capital; worsening conditions for research and innovation; a shrinking space for market-based economic activity; a deteriorating investment climate; decaying infrastructure; growing dependence on a small number of trading partners; and a global transition to renewable energy.

[20] A similar situation arose during the state armament programme implemented from 2011 to 2020, which modernised the Armed Forces. The programme was partly financed through government-guaranteed preferential loans to the defence industry. When the defence industry was unable to repay the loans, the state had to cover the costs instead, which was budgeted as military expenditure in 2016 and 2017. The interest subsidies for these loans were recorded under the appropriation for economic development and therefore did not count as part of the official defence budget.

National Wealth Fund, increased domestic borrowing, or higher taxes. If the budget deficit becomes too large, there is a risk of a vicious circle: higher taxes lead to lower growth; lower growth leads to reduced tax revenues; reduced tax revenues necessitate additional government borrowing; increased borrowing results in higher interest payments for the state, which in turn creates an even larger budget deficit, and so on. A scenario of this kind played out in Russia in 1998 following the First Chechen War (1994–1996). The economic crisis that arose at that time caused widespread poverty and social hardship, but Russia recovered quickly due to high oil prices.

As noted above, liquid assets remain in the National Wealth Fund to finance a relatively large budget deficit in 2025. In addition, there are still non-liquid assets in the fund, potential access to "hidden assets" in state-owned companies (particularly energy companies and banks), and the possibility of confiscating additional Western assets and businesses. There is also room to reduce non-military expenditure in the budget. It is therefore unlikely that financing the budget will pose a serious problem over the next two to three years. On the other hand, there is limited room to increase spending further.

3.2 Oil exports

The main short-term uncertainty for the state budget concerns Russia's oil exports and the oil price, as taxes on oil exports constitute the single largest source of budget revenue. The latest US sanctions have prevented a significant portion of the so-called "shadow fleet" from offloading Russian oil in China and India. The extent to which these sanctions will affect oil exports remains unclear.[21] So far, China and India have shown a willingness to take various steps to facilitate bilateral trade with Russia without directly violating sanctions. A lower global oil price would also reduce state budget revenue. The Russian Central Bank has identified a global recession, with declining demand for oil and other raw materials, as the greatest external risk to the Russian economy. It is impossible to predict the development of the oil price. Current global trends toward increased protectionism and geopolitical tensions may influence the oil price in either direction.

3.3 Inflation

Another short-term challenge for the government is inflation, which continues to rise despite a high key policy interest rate. In practice, inflation has led to a redistribution of purchasing power, in which individuals with incomes indexed below the official inflation rate (such as pensioners) have lost purchasing power, while those

[21] According to a scenario developed by TsMAKP, the new expanded oil sanctions, combined with increased oil production in the United States, could cause Russia to lose approximately USD 50 billion (around 5 trillion roubles) in export revenues per year over the next three years.

working in sectors where wages can be raised faster than inflation have benefited. In 2024, pensions rose by 7.6 per cent, which is lower than the rate of inflation. In real terms, pensions are now lower than in 2013.[22] Overall, however, real wages have increased over the past three years—at least according to official figures. According to a major independent study from December 2023, the average financial buffers and perceived well-being of Russian households improved during 2022 and 2023, particularly among ethnic Russians and in regions with a high concentration of defence industry. For pensioners and residents of the Rostov region, which borders Ukraine, well-being declined during the same period.[23]

The government has made some efforts to compensate for inflation by expanding ad hoc payments to pensioners, families with children, and the families of soldiers. However, as the state budget comes under increasing pressure and inflation continues to rise, it will become increasingly difficult to prevent a trend of growing inequality and deepening poverty.

On 20 December 2024, the Central Bank decided to keep the key policy interest rate unchanged, even though it had previously made clear that it would raise the rate further. The decision was likely influenced by the political leadership. The day before the Central Bank's announcement, President Putin had indicated that he did not wish to see further interest rate hikes.[24] In other words, the Central Bank can no longer be regarded as independent from the government—if it ever was. In any case, the government's expansionary fiscal policy runs counter to the Central Bank's restrictive interest rate policy. The government's stated strategy for combating inflation is to increase domestic supply, including through import substitution, but this is very difficult to achieve given the economy's capacity constraints (see below). As long as the government chooses to maintain military spending at a high level, it will be difficult to lower the inflation.

3.4 Bankruptcies

Government interest subsidies have created a divided market. Companies that the state considers strategically important, such as those in the defence industry, have access to cheap, subsidised, and government-guaranteed loans. Other companies must borrow on market terms, which meant interest rates of over 20 per cent at the end of 2024. High borrowing costs increase the risk of bankruptcies, especially if the growth rate slows. The think tank TsMAKP has warned of a coming wave of

[22] Russian Macro, *Pensii: problema prokorma 40 mln chelovek*, Telegram post, 17 February 2025, https://t.me/russianmacro/20576.

[23] Sinikka Parviainen and William Pyle, *Household well-being under sanctions: Insights from the Russian longitudinal monitoring survey*, BOFIT Policy Brief (Helsinki: Bank of Finland, 2025).

[24] RBK, *Putin zaiavil, chto dazhe Naibiullina ne znaet zavtrashnuiu stavku TsB,* 19 December 2024, https://www.rbc.ru/finances/19/12/2024/676412c39a79470774f3db5a.

bankruptcies and estimates that the share of firms at risk of bankruptcy rose from 5.8 to 12.6 per cent during 2024, measured as a share of total turnover. According to the Central Bank, sanctions are the main reason for the deterioration in corporate finances. A wave of bankruptcies would force the government to choose between financing rescue packages for businesses or risking a financial crisis if companies become unable to repay their loans. Household debt could also pose a problem for banks. Statistics show that the share of overdue household loans has increased.[25]

3.5 Financial stability

The Central Bank considers that the growth in corporate lending and credit risk has been excessive, and in 2024 it introduced stricter macroprudential regulations aimed at safeguarding the stability of the financial system. This policy may have contributed to the decline in corporate lending volumes at the end of 2024. However, the Central Bank faces a difficult balancing act: if policy becomes too restrictive, companies may struggle to refinance and repay their loans, a development that would ultimately become a problem to the banks themselves.

Western sanctions have forced many Russian companies to borrow on the domestic market rather than through international channels. As a result, Russian banks now hold an increasingly concentrated loan portfolio, heavily exposed to a small number of very large Russian firms. In October 2024, lending to the six largest companies — including the state-owned defence conglomerate Rostec — accounted for 68 per cent of the entire Russian banking sector's capital, up from 46 per cent at the beginning of 2022. The Central Bank has identified this concentration as a potential threat to the stability of Russia's financial system.[26]

It is clear that the government's expansionary fiscal policy is creating mounting risks for the banking sector. Since 25 February 2022, banks have been legally required to issue loans to defence companies on preferential terms.[27] Many of these companies have long had poor credit ratings and have received repeated government bailouts over the past several decades. Because defence companies cannot realistically repay their loans without continued state contracts, Russia's financial stability is increasingly dependent either on sustained government procurement for the defence sector or on the nationalisation of their debt.

[25] Central Bank of Russia, *Financial stability review: Q2-Q3 2024*, 15 November 2024. https://www.cbr.ru/Collection/Collection/File/54860/eng_Q2-Q3_2024.pdf.

[26] Central Bank of Russia, *Financial stability review*, 43.

[27] Federal law nr. 29, "O vnesenii izmenenii v Federalnyi zakon 'O gosudarstvennom oboronnom zakaze'", dated 25 February 2022. https://rg.ru/documents/2022/03/01/oborona-dok.html.

3.6 Capacity constraints

The economy is in a situation where increased public spending primarily results in further inflation rather than gains in productivity or higher growth. The labour shortage and negative demographic trends, both of which have been worsened by the war, are causing large state-owned companies to use growing amounts of public funding to compete for a shrinking pool of workers. At the same time, firms are struggling to access new loans for investment in equipment and infrastructure. Sanctions have also driven up the cost of importing items such as machine tools and other industrial equipment. As a result, companies are poorly positioned to expand their production capacity or meet the government's targets for import substitution. The defence industry is also affected by these challenges. It is therefore likely that economic growth will slow further in the coming years. Weaker growth reduces tax revenues, which in turn makes it more difficult to finance the state budget.

3.7 The regions

Some regions and large state-owned enterprises in Russia are heavily dependent on the export of raw materials such as coal, nickel, and gold, or on goods like steel and aluminium. A drop in export revenues in one or more of these sectors can create local problems that require increased spending in the form of subsidies from the central government, thereby placing additional pressure on the state budget.

A current example is the coal industry. Russia's coal exports to China declined in 2024, partly due to capacity constraints in railway transport.[28] This has led to financial difficulties for coal-producing companies in the Kemerovo region of central Siberia. Since the city of Kemerovo and nearby towns are entirely dependent on the coal-exporting companies, the government has temporarily suspended export taxes on coal. This example illustrates Russia's challenges with so-called "monotowns," cities that are completely dependent on one or a few industries. When those industries are no longer economically viable, the government must step in to rescue the companies in order to prevent a local economic crisis. It is not difficult to imagine that multiple crises in Russia's regions and monotowns could eventually force the government to increase spending to keep the regions afloat. This example also shows that sanctions targeting individual sectors, even those that may seem relatively marginal to the national economy, can have severe effects on specific regions and generate cascading consequences.

[28] Central Bank of Russia, *Regional economy: commentaries by Bank of Russia main branches, no. 32.* 5 February 2025. https://www.cbr.ru/Collection/Collection/File/54965/report_11122024.pdf.

4 Conclusions

Economic growth in Russia, driven by high levels of military spending, is beginning to show signs of stagnation in early 2025. Labour shortages and a lack of imported equipment are preventing the economy from absorbing the effects of large-scale public stimulus. The state can continue to finance current levels of military spending and moderately large budget deficits for at least another two to three years by drawing down the National Wealth Fund, raising taxes, and increasing borrowing. Such a policy, however, would result in further inflation and weaker growth. It would also raise the risk of a banking crisis or local economic crises in the regions. The Central Bank is currently failing to curb inflation despite pursuing a restrictive interest rate policy.

The challenges described above present problems for the Russian leadership in the sense that, if they become serious enough, they would force the government to take measures that further worsen economic conditions for the population and for businesses. These challenges are interconnected, mutually reinforcing, and growing more serious over time. At present, however, there is little to suggest that they are so severe as to trigger an unmanageable economic crisis.

The more pressing problem for the Russian leadership is the unpredictable and unquantifiable risk that it may be forced to impose economic sacrifices on the population unless it is willing to reduce military spending. These sacrifices could have far-reaching and difficult-to-control consequences for society at large. The government would, for example, likely have to rely more on repression and coercive measures than on economic incentives to achieve its goals. One sign of this development is that payments to wounded soldiers have been reduced.[29] But increased repression also carries increased costs — for example, a larger police force, expanded security services, and reinforcement of the National Guard. In a more extreme scenario, the government might resort to full-scale economic mobilisation and attempt to convert the country to a more total war economy. Legislation enabling such a transition has already been adopted.[30]

Whether a party at the negotiating table is perceived as strong or not is a matter of interpretation. Russia is keen to appear strong, not least economically. It is therefore important that we do not overestimate Russia's economic resilience. Even if the country manages to finance high military spending in the short term, it is clear that this will come at the expense of future outlays. Every rouble spent today

[29] Aleksandr Golts, *Less Money for War*, Centrum för Östeuropastudier (SCEEUS), 14 November 2024. https://sceeus.se/publikationer/less-money-for-war/.

[30] Emil Wannheden, "Everything for the front? Russia's reluctant economic mobilisation after February 2022," in Forsström, Pentti, *Russia's war against Ukraine: Complexity of Contemporary Clausewitzian War* (Helsinki: Finlands försvarshögskola. 2024).

carries an opportunity cost: it could have been invested in economic development that would have made Russia stronger in the longer term.

The Russian leadership also faces a dilemma in that high military spending contributes to lock-in effects. The more militarised the economy becomes, the harder it will be to transition back to a peacetime economy. Reducing orders to the defence industry will become economically costly, as it would simultaneously slow growth and create problems for the banking sector, a dangerous combination. On the other hand, freeing up resources by cutting salaries and payments to soldiers, veterans, and their families is politically difficult.

One consequence of these longer-term economic challenges is that the planned rebuilding and expansion of the Armed Forces will become increasingly difficult to finance and implement over the coming decades, a development that risks weakening Russia in the long term relative to both the West and China. In other words, Russia faces an intertemporal trade-off in the build-up of its military forces. Other countries face this as well, but Russia operates under greater constraints due to the effects of the war and sanctions. This dilemma was expressed by President Putin in his speech to the board of the Ministry of Defence in December 2024: military expenditure cannot rise indefinitely, since the country also needs investment in the economy, education, and research. This statement stands in contrast to his address in December 2022, when he promised that the army would receive everything it asked for.[31]

The reasoning above suggests that, in discussions about a ceasefire in Ukraine, Russia is likely to prioritise sanctions relief. The highest-priority items are likely to include a normalisation of economic relations, the lifting of oil sanctions, the resumption of gas exports to Europe, and access to frozen reserves.

Access to the frozen reserves alone could finance a budget deficit of approximately two per cent of GDP for five to seven years, a development that would significantly ease the financial burden of renewed rearmament. The sharp rise on the Moscow stock exchange during the Ukraine-related talks between Russia and the United States in February 2025 shows how important normalised economic relations are for Russian companies. A return of Western firms to Russia would help close the investment gap, kick-start growth, reduce inflation, and enable rapid technology transfer. It is against this backdrop that one can interpret Putin's proposal that the United States invest in the extraction and processing of rare earth metals in Russia,

[31] Presidential administration, *Zasedanie kollegii Ministerstva oborony*, 21 December 2022, http://kremlin.ru/events/president/news/70159; Presidential administration, *Rasshirennoe zasedanie kollegii Ministerstva oborony.* 16 December 2024. http://kremlin.ru/events/president/news/75887.

as well as the proposal for joint US-Russian financing of natural resource extraction in the Arctic.[32]

As for the sanctions policy of the United States and the EU, three points can be noted. First, the principle that "every bit helps" still applies: while Russia can adapt to individual sanctions in various ways and reallocate its resources, the cumulative pressure of ever increasing sanctions places a greater overall strain on the economy. Second, there is still room to expand the sanctions regime and increase pressure, even if most available measures have already been implemented.[33] Third, sanctions will need to be sustained over time if they are to limit Russia's future military rearmament.

[32] Polina Trifonova, "Redkozemelnaia politika," *Kommersant,* 25 February 2025, https://www.kommersant.ru/doc/7534002; Natalia Drozdiak and Alberto Nardelli, "US, Russia Mull Cooperation on Arctic Trade Routes, Exploration," *Bloomberg,* 26 February 2025, https://www.bloomberg.com/news/articles/2025-02-26/us-russia-mull-cooperation-on-arctic-trade-routes-exploration.

[33] International Working Group on Russian Sanctions, *Action Plan 3.0: Strengthening Sanctions Against the Russian Federation*, 15 May 2024, https://sanctions.kse.ua/wp-content/uploads/2024/05/actionplan_3.0_5-14-2024_final2.pdf.

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