

# RUSSIAN ECONOMY

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Russia's economy now shows a heavy reliance on "war-dependence". The economic growth seen in the previous year was largely fuelled by significant state budget allocations to the military industry. The more entrenched the Russian economy becomes in military orders, the more challenging the eventual transition away from it will be.

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Western sanctions are inflicting economic damage on Russia, contrary to the Kremlin's official propaganda. However, to further weaken Russia's capabilities, we require additional sanctions and more effective enforcement of existing ones.

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Russia's Rosatom consortium is reportedly engaged in constructing more than 20 new nuclear power plants abroad, including in two NATO member states. But, handling multiple projects simultaneously has stretched its capacities, causing embarrassing issues during the construction of nuclear power plants in Turkey and Belarus.

## THE RUSSIAN ECONOMY HAS BECOME DEPENDENT ON WAR

The Russian Federation's economy is expected to show significant growth in 2023, potentially reaching up to 4%. While this outpaces the growth rates of most Western countries, it is essential to examine the reasons behind the growth. It is crucial to note that this economic expansion is not driven by private investments or foreign trade. Private investments have stagnated since the beginning of the conflict, and the trade surplus has dwindled due to decreased exports and recovering imports.

The economy's growth can be attributed to substantial injections of funds into the defence industry from the state budget at the end of 2022 and the beginning of 2023. These injections amounted to 5-7 trillion roubles, equivalent to 4-5% of Russia's GDP. This boost is reflected in the growth statistics of the manufacturing sector, including companies directly tied to the defence industry and indirectly associated sectors, such as the textile industry, which has seen increased orders for military uniforms. The cash flow from the industry found its way into workers' pockets through wages and corruption costs, subsequently growing retail sales and the consumption of various services. Since spring, the property market in major cities has also seen a remarkable surge. Consumers have chosen to invest their depreciating roubles in stable assets, further driving this trend.

However, the economic boom driven by military orders also has its downsides. Due to sanctions and a general lack of trust, Russian companies are hesitant to invest. The surging demand quickly exhausted available production capacities. Furthermore, there is a severe shortage of skilled labour, aggravated by the fact that cities like Serov, Biysk and Komsomolsk-on-Amur, where a significant portion of defence industry production is located, are not popular among job seekers. Increasing production volumes have led to a substantial wage increase of more than 40% since the beginning of the year. However, due to the low starting point, the defence industry remains relatively unattractive as an employer, and recruitment challenges persist. Another specific concern for Russian munitions producers is the intense competition from their primary customers, the Russian Armed Forces, who offer their personnel wages three to four times higher than the defence industry can provide.

Another drawback of the economic boom is Russia's limited capacity to produce consumer goods. Since the imposition of sanctions, even car production has significantly decreased, and essential consumer goods like electronics, clothing and others have not been significantly manufactured in Russia for decades. Consequently, the surplus money from increased spending on food and real estate automatically translates into higher imports since most desirable consumer goods are imported. The sanctions have had little impact on this trend, occasionally only shifting the origin of imported goods, such as a preference for Chinese brands over Apple phones.

**Russia's exclusion from international financial markets significantly limits its ability to finance its budget expenditures.**

The sanctions imposed on Russia in connection with the war in Ukraine are inflicting significant damage on the Russian economy. Perhaps the most effective is Russia's exclusion from international financial markets, which significantly limits its ability to finance its budget expenditures. Without these sanctions, Russia could allocate much more money to the war, as its still-low debt burden would allow it to borrow the necessary funds from financial markets. Russia must

instead use its reserves, borrow from its limited domestic market, or increase taxes to cover its expenses. In addition, sanctions significantly restrict the availability of essential components and raw materials for the defence industry, complicate international payments, and increase transaction costs, reducing profits for both Russian exports and imports. However, sanctions could be even more extensive, and their enforcement could be more robust.

Growing imports and falling exports are the main factors why the rouble has depreciated by half against the dollar over the past year. This, in turn, fuels inflation and reduces the population's "excess" purchasing power resulting from wage increases. Since 2010, the Russian government has effectively employed this strategy to maintain some form of competitiveness. For example, between 2012 and 2020, real wages in the Russian industrial sector increased by approximately 4,000 roubles, or 40 euros – an average of only 5 euros per year.

Inflation has been rapidly increasing in Russia since the summer of 2023, and to combat it, the Russian central bank already raised the base interest rate by 5.5% between July and September, with likely further increases in the future. However, the hope for a quick victory over inflation is minimal because the stimulus from government spending outweighs the effects of a tighter monetary policy. Nevertheless, the rise in interest rates may eventually hamper consumers' ability to borrow. It may deflate the overheated real

estate market, not to mention the reduced borrowing capacity for companies, further limiting non-defence industry investments that are essential for future development.

To sustain the economy, the Russian government needs to plan for another injection of funds into the defence industry, in addition to compensating for the physical losses on the Ukrainian front and covering the significantly increased costs of its military-industrial complex due to inflation. However, the more entrenched the Russian economy becomes in military orders, the more challenging the eventual transition away from it will be in the future. Russia's civilian economy was not in great shape even before the war and suffered from a lack of investment. After several years primarily focused on war, its peacetime competitiveness has significantly deteriorated.

Основные направления бюджетной, налоговой и таможенно-тарифной политики на 2024 год и плановый период 2025 и 2026 годов  МФР

Таблица 4.1.3. Расходы федерального бюджета в 2019-2026 гг.

Показатель	млрд рублей						
	2019	2020	2021	2023*	2024	2025	2026
<b>Всего</b>	<b>18 214,5</b>	<b>22 821,6</b>	<b>24 762,1</b>	<b>30 265,8</b>	<b>36 660,7</b>	<b>34 382,8</b>	<b>35 587,4</b>
Общегосударственные вопросы	1 363,5	1 507,7	1 759,5	2 324,4	2 171,0	2 286,9	2 410,8
Национальная оборона	2 997,4	3 168,8	3 573,6	6 406,7	10 775,4	8 534,1	7 409,0
Нацбезопасность и правоохрана	2 083,2	2 226,6	2 335,9	3 225,6	3 388,6	3 275,2	3 406,4
Национальная экономика	2 827,1	3 483,9	4 356,6	4 125,6	3 890,0	3 248,1	3 665,6
ЖКХ	282,2	371,5	593,7	856,9	881,3	506,7	381,2
Охрана окружающей среды	197,6	260,6	405,1	347,3	477,5	470,3	522,7
Образование	826,5	956,9	1 064,4	1 464,4	1 546,6	1 311,7	1 411,7
Культура, кинематография	122,4	144,5	146,7	209,0	224,0	176,8	227,3
Здравоохранение	713,0	1 334,4	1 473,9	1 570,0	1 620,3	1 634,5	1 615,3

SELECTIVE FACTS: BUDGET STATISTICS THE RUSSIAN WAY

The Russian finance ministry has not disclosed the actual allocation of federal budget expenses for 2022. Even in the comprehensive document outlining the budget policy for 2024-2026, the overview of one year seems to have mysteriously disappeared. In our assessment, the Russian finance ministry is reluctant to share this data publicly because of the stark contrast between the initial budget structure projected for 2022 and the reality. This also vividly demonstrates Russian government authorities' attitude towards their citizens; there seems to be no perceived obligation to provide even this basic level of information about the use of taxpayer contributions.

## RUSSIA'S ROLE AND POSITION IN THE GLOBAL ENERGY MARKET

In 2024, Russia's natural gas production and export are set to decline, leading to reduced revenue from gas exports, only partially offset by LNG exports due to relatively high prices in European and Asian markets. As the expansion of LNG production capabilities in Russia is contingent on importing significant equipment and components from the West, the completion of planned liquefaction plants will likely be delayed.

Efforts to compensate for the decrease in gas exports through domestic market expansion (such as regional gasification programmes or using natural gas as motor fuel) and exploring new export markets are insufficient to restore Gazprom's revenues to pre-war levels. The Russian government cannot replicate its extraordinary draw from Gazprom's profits in 2022 for budgetary needs.

Russian oil production and export are more influenced by the OPEC+ agreement than by Western-imposed restrictions. Redirecting exports mainly to India and China maintains tax revenue from the oil sector in the Russian state budget at levels comparable to those before the war in Ukraine.

In maritime oil exports from Russia, the increased involvement of insurers registered outside Western countries brings additional environmental risks. The capability of insurers covering Russian oil shipments to manage pollution damages and the compliance of Russian oil tankers with environmental regulations for European waters require further scrutiny.

In 2024, Russian petroleum product exports will continue to be influenced by subsidised domestic motor fuel prices and compensating oil companies for the price differential in exports. The Russian government may again halt diesel exports if domestic prices rise uncomfortably high.



Rosatom's ZiO-Podolsk machine-building plant is buzzing with activity, producing new nuclear reactors and other equipment for both domestic and international projects.

Source: Alexander Nemenov / AFP

## CHALLENGES IN ROSATOM'S NEW PROJECTS IMPLEMENTATION

The Russian nuclear energy consortium Rosatom is managing more than 20 new nuclear power plant projects abroad. Despite a broader understanding of the risks associated with dependence on Russian energy carriers in the West, Rosatom continues to build nuclear plants even in two NATO member countries.

Engaged in multiple projects simultaneously, Rosatom has overestimated its capabilities. Issues in Turkey and Belarus cast doubts on its ability to build new nuclear plants.

The commissioning of Turkey's Akkuyu nuclear plant's first unit, initially scheduled for spring 2024, could face a one-year delay due to the late completion of critical equipment and systems. The delays have been caused by the excessive workload placed on Rosatom's subsidiaries and subcontractors.

The second unit at Belarus's Astravets nuclear plant was already a year behind schedule when it became operational. Ongoing unresolved issues with both units at Astravets do not impede operation but may lead to additional costs and operational pauses in the long run.

Rosatom faces difficulties in staffing its foreign projects with qualified personnel. According to its current plans, it is failing to find professionals with the necessary skills for all of the required positions.

Rosatom may attempt to resolve issues by disregarding regulations to compensate for these shortcomings. This includes (a) sourcing some components and equipment from uncertified firms, as revealed during inspections of the new Leningrad nuclear plant and the first unit of the Belarusian nuclear plant, and (b) employing unqualified personnel, which can lead to a decline in construction quality and violations, as seen in the construction of the first unit of the new Leningrad plant.