



Russia's Economy Feeling the Effects of Prolonged War

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The war against Ukraine has highlighted the structural problems of the Russian economy, including the dependence of much of the state's income on natural resource exports. Among other things, Russia is struggling with a shortage of capital and manpower, while prolonged hostilities are hampering state investment programmes essential for the country's development. The continuation of sanctions by Western countries, particularly on technologies crucial to the arms and mining industries, will make it more difficult for the Russian authorities to rebuild the economy in the future and further militarise the state.

The Condition of the Russian Economy. After more than three years of full-scale war against Ukraine, there has been a slowdown in the Russian economy. According to Russian data, GDP growth will slow to 1.8% in 2025, down from 4.1% last year. This is due, among other things, to a slowdown in domestic demand, including households, with spending on goods and services increasing by just 2.3% in 2025 (5.5% last year) and on state expenditures by 0.6% in 2025 (4.5% last year). GDP will also be adversely affected by the low growth rate of exports, estimated at an average annual rate of only 1.8% in 2025-2027—by comparison, export growth was 45.7% in 2021 and 19.9% in 2022.

Reduced household spending and delayed implementation of state investment programmes, announced by Vladimir Putin in 2024, are among the effects of Russia's military operations. A further protracted war will exacerbate these unfavourable trends, while the need to maintain a high level of security spending (currently 41% of budget expenditure) will force cuts in other spheres and increase the budget deficit, which stood at 1.7% of GDP last year. In the years to come, provided that Russia ends the war with Ukraine, the situation may be improved by the planned launch in 2026 of state projects in, among other areas, industry and high technology, which, according to official calculations, would guarantee additional annual GDP growth of around 1.4% in the medium term.

Key Economic Impacts of the Aggression Against Ukraine. A significant problem for the Russian economy is inflation

(9.5% last year) and the associated high interest rates, currently at 21%. The rise in prices is largely the result of sanctions, which have restricted the supply of goods on the Russian market. The high interest rates have led to a reduction in investment, especially from private funds, and a decline in investment in core capital. This exacerbates the economic slowdown and makes necessary reforms more difficult. More and more companies are also struggling to repay their debts (by March 2021, the interest rate was 4.25%).

The Russian economy is also struggling with a labour shortage (the registered unemployment rate was 2.5% last year, with 5.4% in 2021) as a consequence of war losses and departures for fear of mobilisation (at least 650,000 people have left the country for this reason). In December 2024, Deputy Prime Minister Alexander Novak estimated that there was a shortage of 1.5 million skilled workers on the labour market, with the biggest shortages in transport, construction and the municipal sector. The arms industry is also experiencing problems—at the end of 2024, the Russian government estimated a shortage of 400,000 workers. Official estimates say that this trend is set to worsen and that by 2030, Russia could be lacking at least 2.4 million workers. This indicator is likely to worsen due to war losses and the continuing population loss since 2017, which officially reached almost 65,000 last year.

Another problem is the decline in the rate of industrial production, with growth of 1.1% year-on-year in Q1 of this

year (in Q1 2024 it was 5.6%). There is also a shortage of modern technology, especially for key industries like arms and mining. Without them, it will be difficult for Russia to process oil and maintain its current production levels.

Importance of Maintaining Economic Sanctions. The factor negatively affecting the Russian economy is Western sanctions, particularly those related to oil purchases and the freezing of Russian foreign assets. The primary source of revenue for Russia's budget is hydrocarbon sales, which in 2024 brought in more than RUB 11 trillion (about \$129 billion), accounting for more than one-third of total revenue (RUB 36.7 trillion). The draft budget for 2025 assumes that more than 27% of revenues will come from oil and gas sales. All the more important for the stabilisation of the Russian budget is the "shadow fleet", which in 2024 carried 167 million tonnes of oil, or 61% of Russia's total maritime oil exports worth RUB 7.8 trillion (about 21% of budget revenues).

Meanwhile, the freezing of Russian capital has prevented it from being used for military operations. It has also translated into a reduction of the Prosperity Fund, which the Russian government has tapped into instead of capital accumulated abroad. The fund consists of liquid assets (currencies and gold) and funds invested in various financial instruments. As of March, these amounted to almost RUB 12 trillion (over \$133 billion), equivalent to 5.6% of Russian GDP. However, part of this sum, which is invested in, among other things, shares of Russian companies, is *de facto* unsellable. What is more, since the beginning of the full-scale invasion of Ukraine, the fund's resources have shrunk by RUB 1.6 trillion, which, taking into account the weakening of the Russian currency, means that it has decreased by \$50 billion. The part that was used were mainly liquid assets, which were used to bail out the Russian economy. Sanctions have also blocked Western investment, especially in Russia's key mining sector, and made it more difficult to acquire modern technology, which weakens Russia's ability to rebuild its military capabilities.

Conclusions and Recommendations. Russia's economic policy is not entirely subordinated to the ongoing military action but it is nevertheless strongly affected by the war with Ukraine. The war has also exacerbated the structural problems of the Russian economy, stemming from years of dependence on hydrocarbon sales for state revenues, lack of reform, delays in state investment programmes, corruption, and the oligarchic system.

A war that is prolonged further and associated sanctions will exacerbate negative economic processes, including by additionally diminishing the country's financial reserves, although Russia still has resources for about 2-3 years of war at current spending. This means that Russia will not seek to completely sabotage potential peace negotiations with Ukraine, although it will try to get Western countries, including the U.S., to agree to favourable terms, even at the cost of prolonging the hostilities. One of Russia's most important demands will be that Western sanctions be lifted as soon as possible to allow for an increase in the supply of goods on the market and a reduction in inflation, as well as the acquisition of modern technology. The Russian government may also make a peace agreement with Ukraine conditional on Western investment in the mining sector and it will remain interested in acquiring military and dual-use technologies. It will try to mitigate economic problems by developing foreign trade. Its most important trading partner is China, with a 33.8% share of last year's goods turnover, followed by India (8.8%), Turkey (8.3%), Belarus (7.1%), and Kazakhstan (4%). It is to be expected that Russia will want to further increase its trade volumes with these countries.

However, Western countries should not abandon the restrictions already implemented. The Russian government will continue to spend a significant part of the revenue raised on armaments. The rapid lifting of economic sanctions and allowing Russia access to modern technology after the war will therefore support its militarisation. It will contribute to a reduction in the security of European states and will have a negative propaganda effect. It will also be important to maintain and extend restrictions on the shadow fleet, the operation of which has allowed Russia to maintain its level of income from hydrocarbon sales, despite the reduction in volumes.

The EU should also force Member States to strictly comply with Directive 2024/1226 introducing restrictions for violating the sanctions regime. It would also be worthwhile for the EU to draw up consequences for partner countries, including those in the South Caucasus and Central Asia states that help Russia circumvent the restrictions, mainly by re-exporting embargoed goods. It could do this by threatening to limit cooperation, including financial aid. At the same time, frozen Russian assets should be designated for post-war reconstruction in Ukraine or, in the event of a prolonged conflict, for military support.