BOFIT Policy Brief
2025 No. 4

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The impacts of war on Russia's economic future

Bank of Finland, BOFIT
Bank of Finland Institute for Emerging Economies

BOFIT Policy Brief
Editor-in-Chief Sanna Kurronen

BOFIT Policy Brief 4/2025
26 February 2025

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ISSN 2342-205X (online)

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Abstract

Three years of war, sanctions and Russia's isolation from the global community have changed its economy in many ways. Some changes such as the degraded business environment and increased government presence in the economy are likely to persist. War has also exacerbated Russia's already poor demographic trends. While a break in the war and relaxation of sanctions would eventually at least partially reinvigorate Russian trade with the European Union and other economic blocs, Russia's heavy dependence on China undoubtedly continues. An end to the war, even an ugly end, would reduce pressure for public sector spending and help Russia get inflation back under control. A prolonging of the war and continuation of the current sanctions regime would mean further increases in public spending as sustaining the war is non-negotiable for the current government. Inflation would remain high and economic imbalances worsen. In all our scenarios, Russia's share of the global economy continues to decline. Russia, however, has the resources it needs to continue the war, the desire to fund its armed forces and the commitment to support its military-industrial complex come what may.

Keywords: Russia, economy, war, sanctions

Where to now?

Despite Russia's abiding dependence on hydrocarbon production, war and sanctions have changed its economy. This brief considers possible development paths for the Russian economy to the end of this decade. Many – but certainly not all – of these plausible outcomes depend on how the war in Ukraine plays out. The fate of Russia's long-term growth potential is left for another discussion as we restrict our discussion to trends over the next few years.[1]

Preparing for multiple futures

Russia's full-on invasion of Ukraine and the resulting economic sanctions on Russia have caused major shifts in the Russian economy over the past three years. In this first part of the discussion here, we highlight the most important changes. BOFIT Policy Brief 3/2025 discusses these changes in greater detail.

Money, manpower and matériel

Russia has significantly increased government spending to cover war-related costs, blowing through most of the national savings in the process. Many companies have been granted inexpensive government-subsidised loans, particularly firms operating in branches related to the war effort where output has skyrocketed. At the same time, the government's role in the economy and in bolstering wartime branches has increased. From the leadership's standpoint, nothing is more important than meeting the war's needs, so fields and firms that support the war effort are heavily favoured at the expense of others. The government also heavy-handedly intervenes in company operations through regulation, guidance and even seizures of businesses or their parts.

Increased output requires additional labour inputs. Russia's labour force was stretched thin before the invasion, but now labour shortages are worse than ever. Hundreds of thousands of working-age men have been mobilised and shipped to the front or left the country to avoid the war. The number of guest workers in Russia has also fallen. Wages have risen rapidly in the face of labour shortages, supporting private consumption and driving up demand.

Prices are gradually adjusting to Russia's rapid growth in demand. Russian inflation began to accelerate in 2024, approaching double digits in the second half of the year. To quell inflation, the Central Bank of Russia (CBR) aggressively raised its key rate, a blunt move that in part reflected the fact that normal transmission of monetary policy signals have been muted by the government's generous interest subsidies.

Sanctions-related changes

Dozens of countries joined to impose wide-ranging economic sanctions on Russia following its full-on invasion. Sanctions regimes have transformed Russia's international economic relationships. The CBR has abandoned its market-driven exchange rate policies, capital controls have been reimposed and the ruble is no longer a freely convertible currency.

[1] For a discussion of Russia's long-term growth potential, see e.g. CEPR Policy Insight No. 131, [Policy Insight 131: Russian economy on war footing: A new reality financed by commodity exports | CEPR](#).

Foreign capital inflows to Russia have largely dried up due to war and sanctions. Russia's foreign trade has decreased. Russian trade with countries in the sanctions coalition has collapsed, while trade with Asian countries, particularly China, has soared. At the same time, the role of Western currencies in Russia's foreign trade and financial markets has declined sharply, replaced to some extent by a much-increased role for the Chinese yuan.

Russia's status on international markets has weakened. Although it remains dependent on commodity exports and technology imports, Russia's new big customers – China and India – hardly see Russia's role as energy supplier is anything near its former significance to EU countries in the pre-war era. Indeed, Russia's importance to China remains relatively small. Thus, Russia's ability to use foreign trade in strong-arming other countries has decreased considerably.

War and sanctions also dictate Russia's near-term economic development

War and sanctions have been central factors in the development of the Russian economy over the past three years, so they must be considered in evaluating Russia's possible economic paths in the years ahead. Some of the changes to the Russian economy caused by war and sanctions may be considered transient while others are likely to be long-lasting. We offer with four plausible scenarios in which war and sanctions continue, the war ends, sanctions end, and demand for hydrocarbons decreases.

Status quo continues

If the war continues and sanctions remain in place as before, the difficult conditions now facing the Russian economy would gradually deteriorate. Government spending would have to be further increased to fund the war. The liquid assets of the National Wealth Fund, the country's savings from oil earnings, would be drained completely by the end of this year. Once the money runs out, the government would then have to slash non-military spending and increase domestic borrowing. With further problems, the central bank's "lender of last resort" function might even be exercised. This scenario tacitly assumes the government would try to bail out the economy no matter the risks involved.

As the ceiling on an economy's production capacity is reached, no amount of spending can increase output. Instead, prices rise. In Russia's case, the central bank would have to raise it key rate further to quell inflation. Firms other than those enjoying subsidised loans would be overwhelmed by the credit crunch and cut back their operations. If Russia abandons tight monetary policy, inflation accelerates and purchasing power erodes further. In the worst case, Russia would enter a runaway inflation spiral that drives the economy into crisis.

Sanctions affect economic conditions in Russia more than ever. They reduce Russian export earnings and budget revenues. They worsen capacity constraints. Many import goods are scarce and expensive. Investment in new production capacity becomes harder. Sanctions also make the Russian economy more vulnerable to new external shocks.

Slowing growth and tighter financial conditions, however, are unlikely to cause broader dissatisfaction on the part of average Russians, because the economy has been growing in recent years. In addition, propaganda and repression discourage public displays of social unrest. A long slide in oil prices or the end of Chinese support, however, could force Russia to seek unsavoury solutions as Russia will not abandon its war solely because of domestic economic troubles.

The war ends

Should there be a ceasefire or end to the war, Russia could gradually phase out policy measures that have generated large economic imbalances. There would be no need to further increase war spending, even if the current level could be sustained with the tax increases already implemented. Fiscal policy could also revive the earlier principle of saving for the future and put government finances back on a sounder footing. Similarly, measures such as government loan subsidies could be gradually phased out. If needed, some losses could be shifted onto the banking sector.

The current tightness of labour markets would ease somewhat without the need to send men to the front. Demand would soften and inflation pressures ease. GDP growth would also be lower, but such a slowdown is hardly likely to cause widespread dissatisfaction. The last two years have seen relatively robust growth in Russia, so a minor slowdown could likely be brushed off with effective propaganda messaging. Lower inflation would also benefit purchasing power and provide the CBR with room to cut its key rate. Indeed, between 2014 and 2019, Russian GDP grew at an average pace of just 0.9 % a year without any major political consequences.

Sanctions lifted

If sanctions were lifted or downsized, Russia's international economic relations would likely recover to some degree. In the short term at least, foreign capital could return quickly to Russia in the form of portfolio investment or in the form of credit seeking high returns. To achieve a broad-based increase in capital inflows, Russia would have eliminate its own capital controls.

At the same time, goods and services trade between Russia and sanctions coalition countries would gradually restart, even if arranging the redeployment of production chains would take time. The lifting of restrictions on Russian access to international payments systems would also ease foreign trade between Russia and countries not participating in the sanctions coalition.

A longer-term commitment to e.g. making Russia attractive again to direct foreign investment would take years to realise. While the political risks associated with the Russian market would ease substantially if the war ends, most countries would consciously seek to avoid overdependence on Russian commodities. Moreover, it is unlikely that many of the restrictions on technology exports would be lifted quickly.

Russia's export earnings would rise and export volumes of certain goods could increase. Sanctions have had no effect in limiting oil export volumes, so the lifting of sanctions should have little impact in this respect. The impacts of sanctions on natural gas exports have also been limited, but any recovery in exports would be restrained by lack of capacity. Russian imports would likely increase as the country would again have access to a wider variety of imported goods and it would be cheaper and easier to acquire such goods.

Falling demand for energy hydrocarbons

War and sanctions have done little to change the fact that production and exports of energy hydrocarbons remain essential to the Russian economy. Oil, petroleum products, natural gas and coal together account for roughly 60 % of Russia's export earnings. Even if public sector revenues from sources other than oil and gas have risen faster, the latter still account for about a third of federal budget revenues. Energy companies (along with state-owned banks) are Russia's largest corporations. These large enterprises typically control substantial portfolios of subcontractors operating in many fields.

Fossil-free energy production or electrification of the transportation system are not part of serious debate in Russia, and this situation is unlikely to change even if the war ends. Russia lacks the political will and the expertise to implement advanced renewable energy or other alternative energy economy solutions on a large scale.

Moreover, growth in global demand for oil and coal is expected to an end in just a few years. The International Energy Agency (IEA) expects global demand for oil to begin falling gradually after 2030, with demand for coal slipping into decline even sooner.

Changes in global demand, however, are so slow that they are unlikely to affect the Russian economy over the coming five years. Demand for fossil fuels will continue to rise in Asia (especially India), even if consumption is OECD countries continues to fall. Unless sanctions are tightened significantly, Russian energy producers will continue to find export customers for their products.

Lasting economic changes

The war, which has laid bare the primary political goals of the current Russian administration, has also relegated economic policy to the back burner. The government's focus, no matter the cost, is to assure adequate production capacity to continue the war effort. If the war in Ukraine ends or there is a ceasefire, the government would likely see little need to further *increase* production capacity, but it would also refrain from immediate be downsizing of wartime production or redirecting production to civilian purposes.

Russia's behaviour in wartime mode demonstrates the government's impunity to market-based economic frameworks. The effects such brazen moves on foreign investors is overlooked completely by the current administration. Of course, Russia is ready to take money from Western countries, just not willing to make the effort to create conditions that could attract and keep foreign financing flows. Moreover, even if Russia were to instate a market-friendly policy framework tomorrow, the risk would persist that the government would abandon that framework as soon as the country's policy goals again change.

The same goes for the business environment in a larger sense. The behaviour of government officials towards the business community has become more capricious and subject to personal loyalties. Property protections are weaker than ever. Officials may seize firms or order them to accommodate their wishes without having such excesses questioned. Three years of such practices have become so ingrained and accepted that is hard to imagine officials would simply cease their bad behavior even if the war ends and sanctions are lifted.

Some of the shifts in Russia's international economic relations are likely to be long lasting. These changes in trade relations have ossified over the past three years, and there is little desire or even possibility to again change them quickly. The relations between and sanctions coalitions will remain scarred by uncertainty and suspicion for many years, making the parties reluctant to take on excessive risks or dependencies. Russia is also unlikely to abandon its perennial emphasis on import substitution, even the results have been modest. China will remain Russia's most important economic partner.

At the same time, Russia's long-term position in the global economy has weakened. Russia's status in China's commodity markets is much weaker that it was earlier in Europe. Russia's economic leverage with other countries has lessened significantly.

War was a turning point

No matter how things go at the front and no matter whether a ceasefire is implemented this year, the future of the Russian economy looks much different than it did before 2022. The structure of the economy and the principles upon which economic policy are based have changed. Larger amounts are being spent on the armed forces and military industries than earlier. In foreign trade and foreign policy, relations with China (and dependence on China) take higher priority than earlier. Most of these changes are lasting.

At the same time, it should be noted that many of the basic factors governing performance of the Russian economy have not changed. Russia remains heavily dependent on exports of energy hydrocarbons for income and tax revenues. The low birthrate sets its own limit on economic growth. War only reinforces this negative trend.

Russia will remain a world-class player in the energy sector in coming years, but will also account for a contracting share of the global economy. This situation assures that the necessary resources for making war and the related industrial activity can be sustained at the current level, and that war can remain the government's top priority.

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ISSN 2342-205X